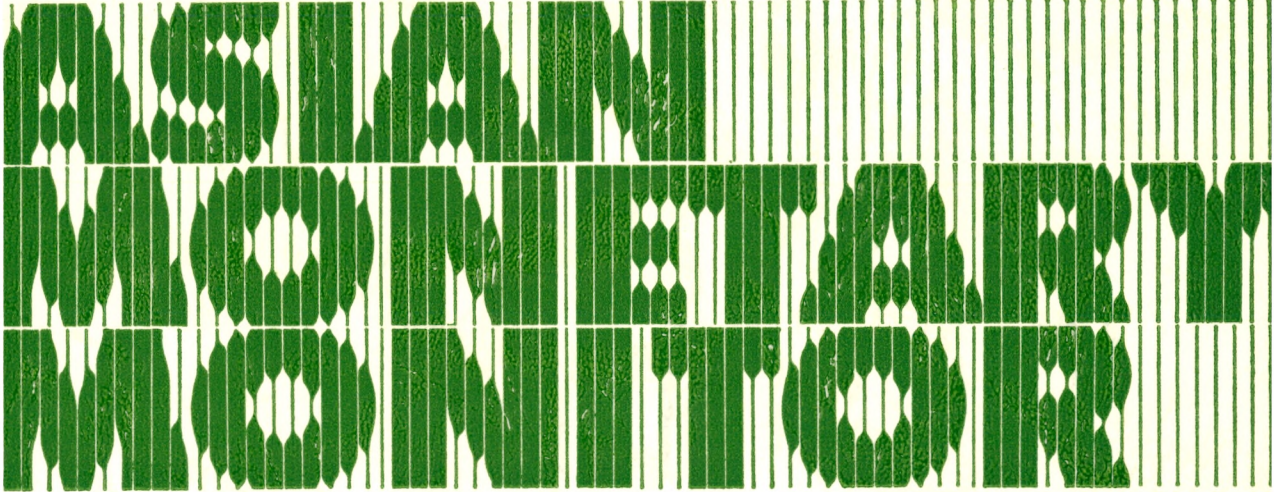




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

THE OUTLOOK FOR COMMODITY PRICES

The effects of tight money policies and world recession continued to be felt in commodity markets in 1982, when nearly all commodities suffered sharp price falls. High interest rates made stockpiling by consumers and producers expensive, and official attempts to support prices failed in the face of depressed demand. International commodity agreements came under pressure as both producing and consuming nations faced severe domestic economic problems. Between October 1981 and the end of 1982 the buffer stock manager of the International Natural Rubber Organisation spent nearly US\$300m to stockpile over 260,000 tonnes of rubber and yet in January 1983 the price of rubber had fallen to a new low. For tin, the year-long support operation which ended in July 1982 was ultimately unsuccessful. The United States and Bolivia pulled out of the International Tin Agreement, and tin prices were only held at the Agreement's floor price by export controls, with ITA members cutting output by about 35 percent. Yet the world tin surplus is now of the order of 80,000 tonnes, roughly two-thirds of which is in the hands of the International Tin Council's buffer stock manager.

Against this background, what is the outlook for commodities in general and in particular the regional commodities - timber, tin, rubber, palm oil and sugar?

CHART 1: WORLD COMMODITY PRICES

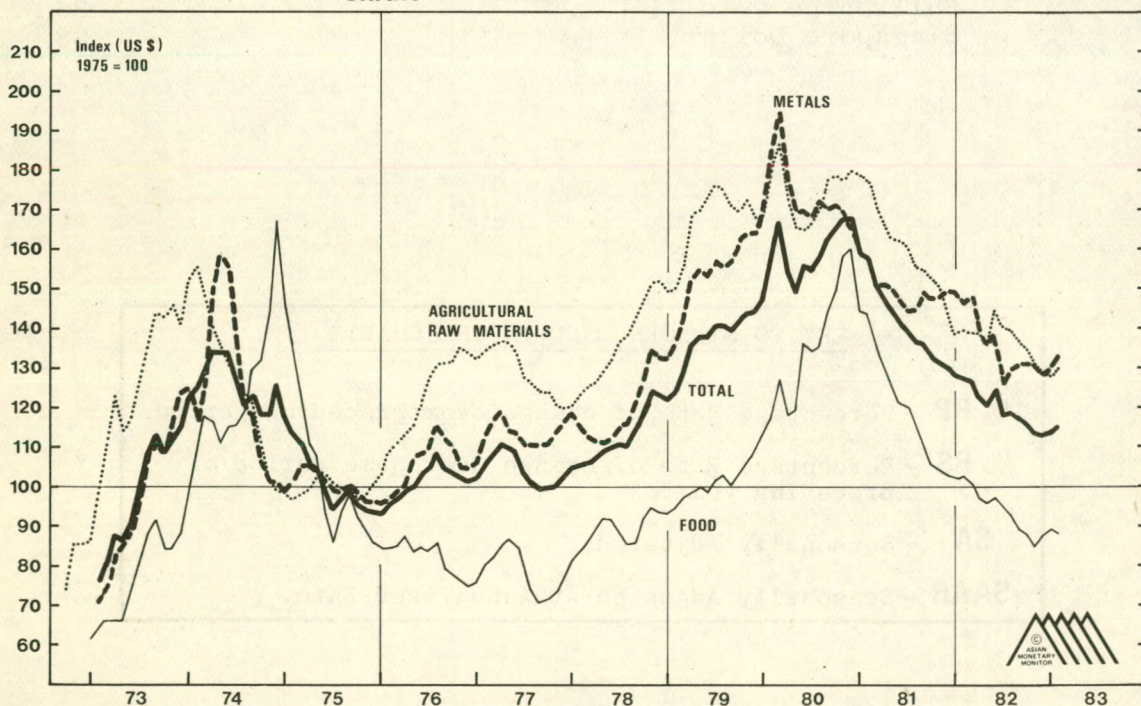


Chart 1 illustrates the price trends in US dollar terms in the broad categories of commodities since the early 1970's. It clearly shows the two big commodity booms of the 1970's - the first in 1973 and the second in 1979/80. The surge in commodity prices in 1973 followed directly from the expansionary policies pursued by the US Federal Reserve in 1970-71 when the US money supply (M2) accelerated from 3% growth to almost 14%. This huge increase was transmitted abroad via the fixed exchange rate system, producing similar enormous increases in money in virtually every economy outside the communist block.

The second surge in commodity prices was delayed until 1979-80. The advent of floating exchange rates meant that industrial countries were free to follow independent monetary policies and thus despite the US money supply again accelerating very rapidly (from 6% to 14% in 1975-76) other countries were not so expansionist and instead allowed their currencies to appreciate against the US dollar. This monetary restraint by countries such as West Germany, Japan and Switzerland in 1976 and 1977 meant that the world economy was not operating at full capacity. The demand for agricultural raw materials, cereals, and metals remained slack. (Even the price of gold at the end of 1977 was still only \$165 compared with a peak of \$186 in 1974, though it had fallen to almost \$100 in the interim.) Nevertheless, because the boom of 1972-73 was so fresh in their memories, many people expected a renewed commodity boom as soon as the world economy recovered in 1975. Therefore the chart shows a series of false dawns in 1976, 1977 and 1978. The problem with each short-lived upturn was that basic industrial demand remained weak, so most of the commodities purchased in each uptick merely ended up as excess inventories with speculative buyers ultimately seeing prices fall again. The second commodity boom finally got under way in 1979-80, extending into early 1981, when all the major economies (U.S.A., Japan, West Germany, U.K.) reached the peak of their respective business cycles.

It seems likely that there will be no big surge in commodity prices of the sort witnessed in 1973 and 1979 in the immediate future. The widespread adoption of floating exchange rates means that the business cycles of different countries will not be as closely synchronised as they were in 1972-73, and the commitment of the major central banks to long term stability in monetary growth means that we are less likely to see a rapid and sustained upsurge in the world money supply. Nevertheless, with some possibility of a strong recovery in the US economy leading to a pick-up in world trade there could be a recovery of some sort in commodity prices this year and within the overall trend some commodities will probably post fairly good price gains.

There are a number of reasons for believing that the recovery in the US could be a strong one: consumer price inflation for 1982 registered only 3.9%, and with the relatively expansionary policies pursued by the Federal Reserve over recent months there is ample liquidity to support a recovery.

Interest rates have fallen sharply since June. The composite index of leading indicators has risen in eight out of the last nine months, posting its largest gain in December, and capacity utilisation is at an all-time low suggesting there is also ample physical capacity available to support a strong recovery.

The two sectors leading the way in the US recovery appear to be housing and autos. Traditionally, these two sectors have benefited quickly from an improvement in consumer spending. Housing starts totalled only just over one million units in 1982, but with lower interest rates they are likely to pick up strongly in 1983, and FHA-insured mortgage applications are already indicating this. For autos, 1982 was a disastrous year but auto inventories are now at a 12-year low and sales are climbing. Considerable pent-up demand for autos exists (the average US car is seven years old) and US auto-makers already plan to build 35% more cars this quarter than in the first quarter of last year.

For commodities, the two most obvious beneficiaries of a recovery led by housing and autos are, respectively, timber and rubber. Chart 2 depicts the annual level of housing starts in the US and the annual percentage change in the US dollar price of sawn wood. Although the level of US housing starts is only one of many determinants of the price of timber, with housing starts likely to rise from just over 1 million units in 1982 towards 1.5 million units in 1983 the implication is obviously bullish for timber, and although the forest products market is depressed now we should see a fairly rapid improvement over the course of this year.

Chart 3 compares the index for auto production in the US with the year-on-year change in the price of rubber (using quarterly data). The strong pick-up in auto sales and production anticipated for 1983 would suggest that, other things being equal, rubber should be among the best performing commodities this year. Indeed Chart 4 confirms, at least for Malaysian commodities, that the rubber price tends to rise early in the business cycle. Unfortunately, however, there are a number of negative factors for both the short term and longer term outlook for natural rubber. The level of stocks held by the International Natural Rubber Organisation is now quite high with some estimates placing it at as much as 280,000 tonnes (or between 7% and 8% of world annual production). Yet despite continued purchases by the buffer stock manager, in the middle of January the price was falling close to the level at which INRO is obliged to buy to prevent further price falls for the first time. If stocks reach the 300,000 tonne level then a three percent cut in the buffer stock price range would have to be considered. There is little action producing nations can take unilaterally, one attempt in September - by Malaysia, Indonesia and Thailand - to withhold stocks from the market having already failed.

The longer term problem for natural rubber comes from the continuing threat posed by synthetic rubber. Natural rubber

CHART 2 : U.S. HOUSING STARTS AND THE TIMBER PRICE

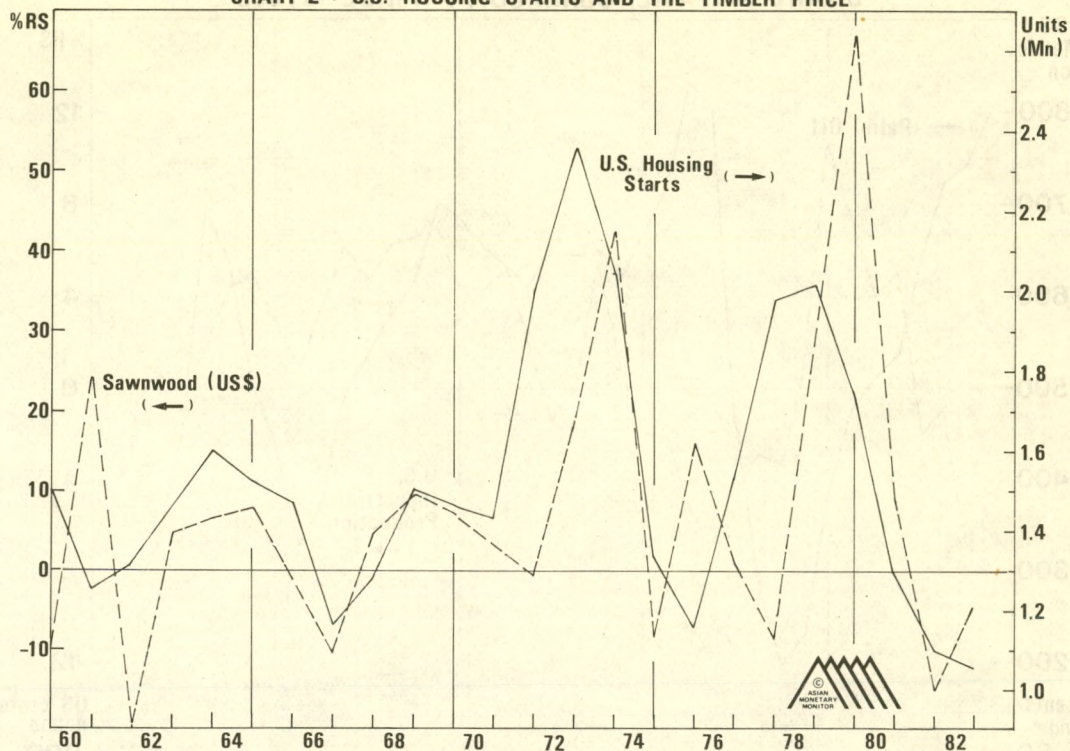


CHART 3 : U.S. AUTO PRODUCTION AND THE RUBBER PRICE

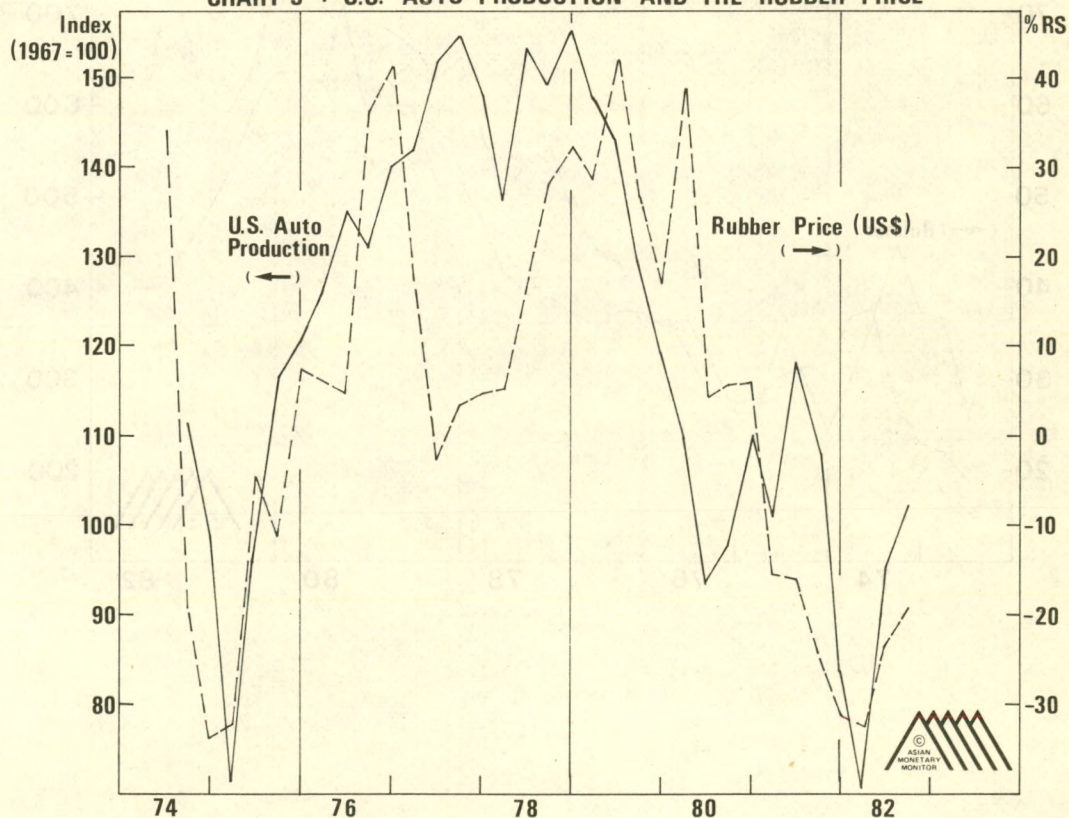
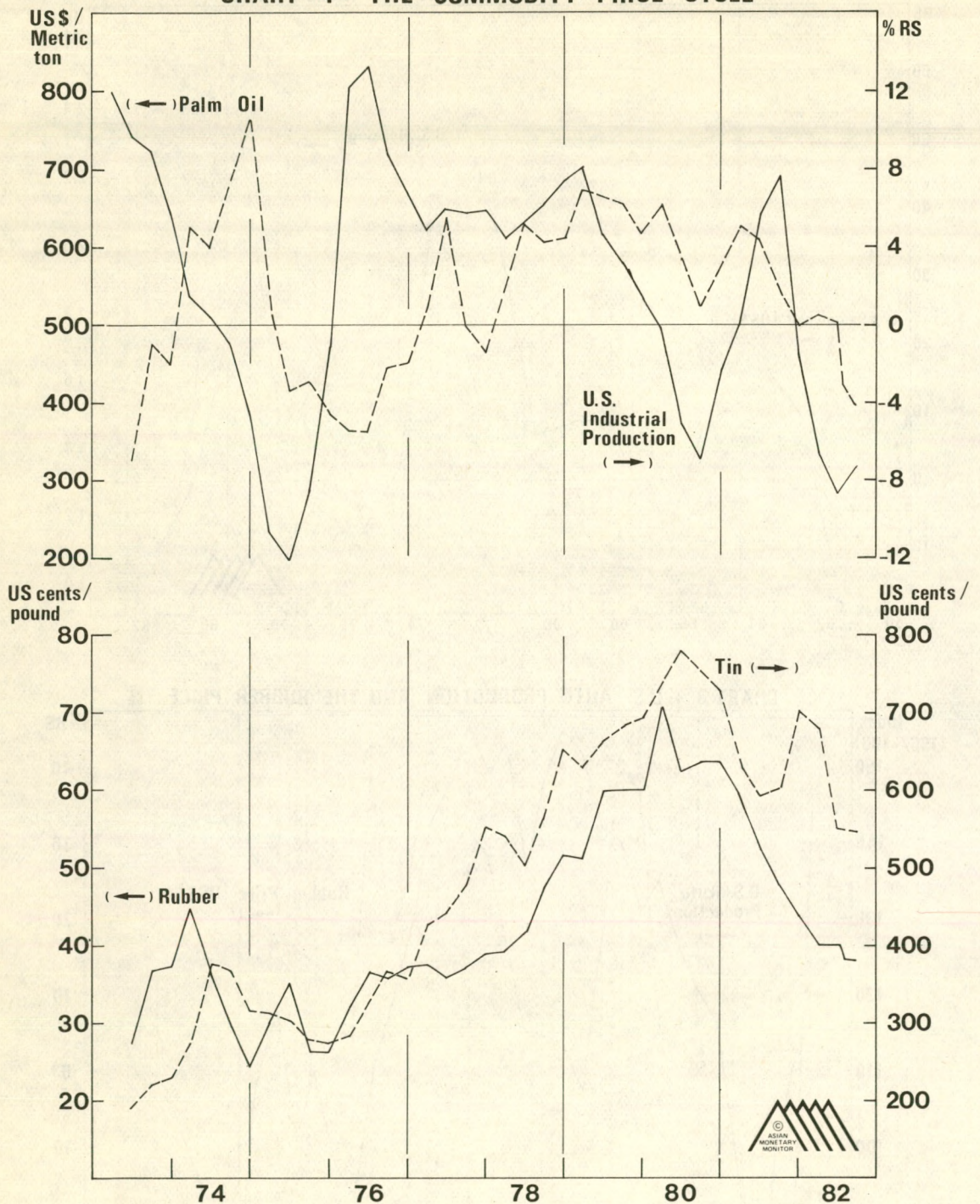


CHART 4: THE COMMODITY PRICE CYCLE



accounts for only 30% of the total world rubber market, the bulk being taken by synthetic rubbers, more suited to the making of radial ply tyres which have taken an increasing share of the world tyre market. The US imports four and a half times more synthetic than natural rubber and any declines in oil prices are likely to add more impetus to the synthetic rubber market.

Nevertheless, increasing uses for natural rubber are arising in engineering and the short-term outlook remains optimistic. This will be of significant benefit to Indonesia and Thailand and particularly Malaysia which produces one third of the world's natural rubber.

The recovery in commodities so far has been led by the metals. Gold and precious metals have risen on the back of fears concerning the stability of the world banking system and a renewed upsurge in world inflation. Non-ferrous metals have risen in sympathy and the tin price has now risen from the bottom reached after the end of the support buying operation in July. Buying operations by producer interests had pushed the price of tin to an all-time high on the London Metal Exchange in February of 1982, but it was impossible to sustain and producing members of the International Tin Agreement were eventually forced to cut output by 35% in an attempt to maintain prices. Seven leading tin producing nations including three of the ASEAN countries (Malaysia, Thailand and Indonesia) have now agreed to form an association to protect producer interests, the charter for which should be adopted in March.

The world tin surplus is now of the order of 80,000 tonnes, roughly two-thirds of which is in the hands of the buffer stock of the International Tin Council. Obviously this surplus will inhibit any rapid upturn in the price of tin, but the overall outlook for tin is quite favourable. As with copper, sharp falls in consumption in 1981 and 1982 have led to reductions in production capacity which could not be quickly replaced in the event of an upturn in world demand. Thus in the face of a sustained recovery in world economic activity, once current stocks have been exhausted we are likely to see a fairly strong recovery in the tin price.

The outlook for the remaining commodities is not so certain. The Malaysian government themselves are very optimistic on palm oil, foreseeing their own export volume rising by 15% in 1983, with the average price rising by 6%. Indeed, the price has already risen strongly from the October low of M\$630 per tonne, reaching M\$815 by end December. Significant increases in production were achieved in 1982 with production for the whole year at 24% above its 1981 level. This was achieved due to improvements in pollination methods and increases in crop area. Average monthly crude stocks are now roughly two-and-a-half times their year earlier levels and it seems more likely that, despite the rise so far, the pattern exhibited in previous cycles (Chart 4) whereby the palm oil price has peaked late in the cycle will be repeated in this upswing.

The commodity to perform most poorly in 1983 is likely to be sugar, which is an important export of both the Philippines and Thailand. This would mirror the situation in 1982 when sugar was the worst performing of the major commodities, its price at the end of the year being roughly 50% below its price at the beginning. With world output much greater than consumption the world surplus stockpile is now above 30 million tonnes, or equivalent to 4 months world production. If it had not been for significant purchases by China and the Soviet Union, whose own crop was poor, the state of the world sugar market could have been even poorer in 1982.

The problem has basically arisen due to the vast increase in EEC production since the world sugar shortage of 1974-75, supported by the price support mechanisms of the Common Agricultural Policy. With the world market price of sugar at £85 per tonne the EEC has been paying domestic producers £365 per tonne, dumping much of the surplus on the free market.

The second major factor has been the import quotas introduced by the US in May 1982 to protect domestic producers which diverted over a million tonnes of sugar on to the world market.

Unfortunately apart from the short term problems the demand for sugar is also in secular decline. While the total world market for sweeteners is now growing at only a very slow pace, an increasing share is being taken by sugar substitutes. Artificial substitutes now take between 13% and 14% of the overall market and this share is growing over time. Thus, although we are unlikely to see further price declines in 1983, the scope for rises in the sugar price is limited and producers would be lucky to see the price of 14-15 cents/lb that represents the cost of production in the Philippines.

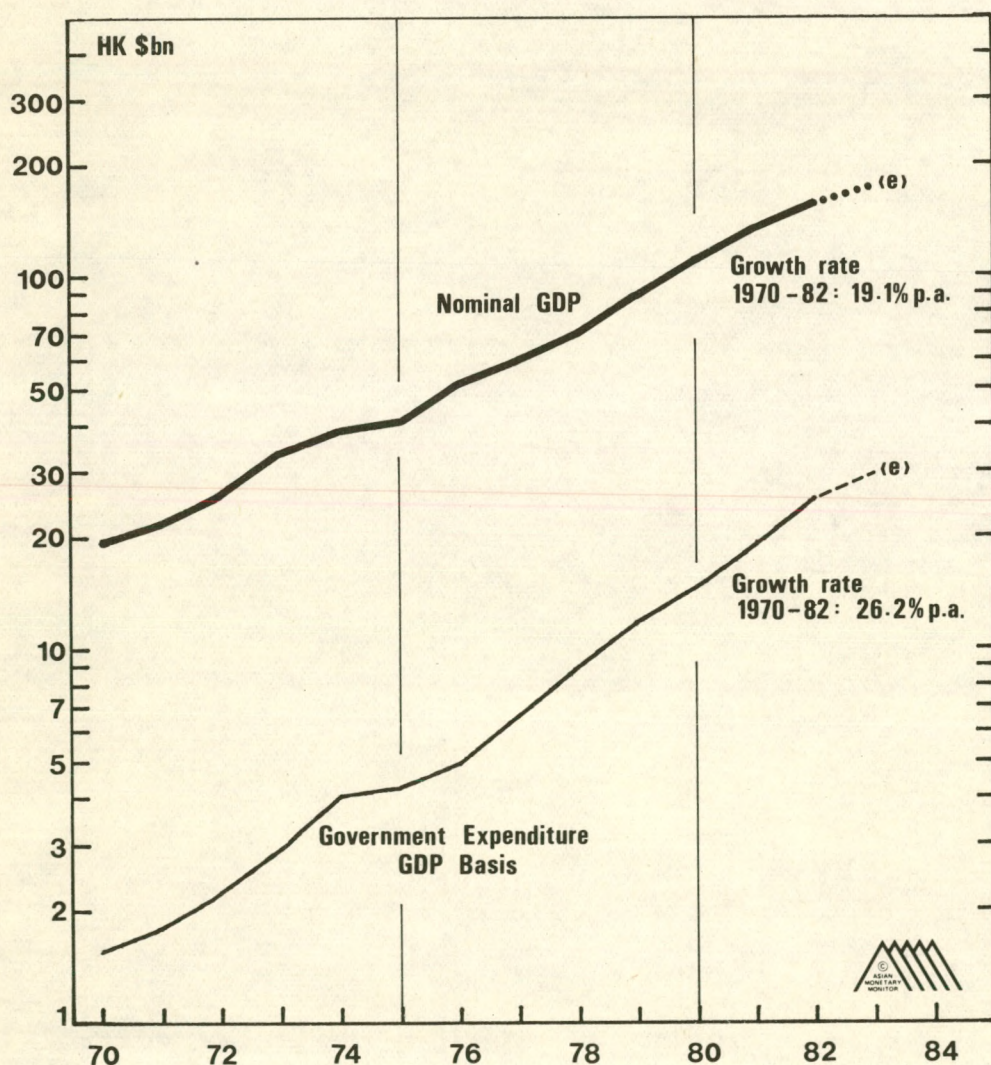
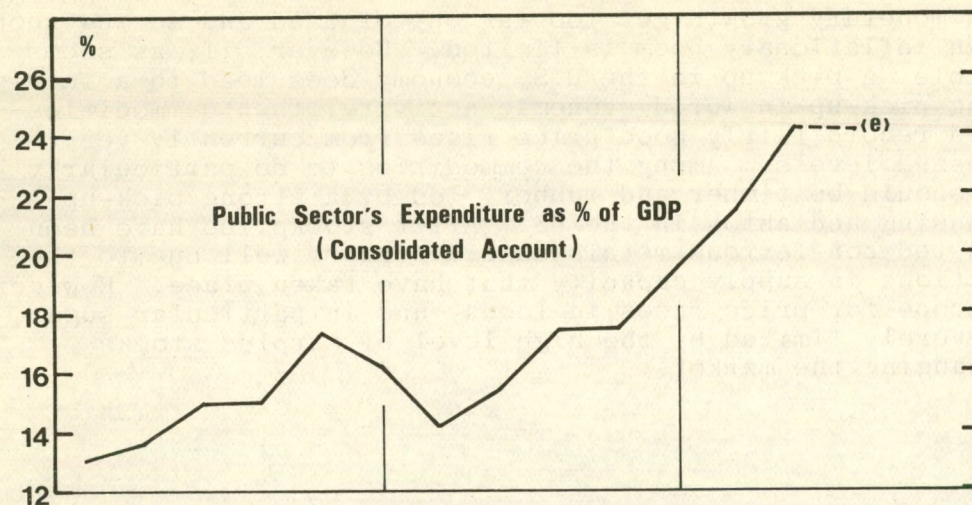
The expected poor performance of sugar confirms the trend evident in Chart 1 whereby foods tend to be very late in the commodity price cycle. This is probably due to the fact that as perishables they do not represent an inflation hedge and also due to the generally higher level of official stocks resulting from the widespread use of agricultural support programmes. Nevertheless, the outlook for South-East Asia's other main food crop - rice - looks somewhat more promising. Prices have been depressed by the 1981-82 worldwide bumper crop, but with the current crop affected by unfavourable weather conditions particularly in Africa, India and Indonesia the expectation is for price rises of the order of 15% in 1983. However the level of stocks is currently high, with stocks in the US, for instance, currently at an all time high of 13.3 billion bushels, up by more than one third from the 1981 level. Nevertheless with a reduction in the sown area, US production is expected to drop by 15% and stocks should be able to be absorbed.

FORECAST: Sharp, speculative rises in the prices of commodities, as witnessed in 1972-73 and 1979-80, are most unlikely in 1983. This is because Central Banks are now unlikely to let aggregate world monetary growth get too far out of hand and so the scope for an inflationary boom is limited. However, if, as seems possible, a pick-up in the U.S. economy does lead to a fairly strong pick-up in world economic activity, then commodities should record fairly good price rises from currently very depressed levels. Among the commodities to do particularly well should be timber and rubber, led by a strong pick-up in housing and autos in the US. After stockpiles have been exhausted non-ferrous metals should perform well due to the reductions in supply capacity that have taken place. However, the scope for price rises in foods, and in particular sugar, is severely limited by the high level of surplus stocks overhanging the market.



HONG KONG : CHART 1

THE GROWTH OF THE PUBLIC SECTOR



GOVERNMENT KEEPS ON GROWING

In the past decade Hong Kong has seen an enormous growth in the rôle of Government in the economy. In broad terms, government expenditures as a percentage of GDP have grown from 15.0% of GDP in financial year 1972-73 to an estimated 24.2% for the financial year 1982-83. The rapid growth of government is illustrated in Chart 1 opposite which shows that over the period 1970-81 government expenditures grew at a compound annual rate of 26.2% p.a. (in nominal terms) compared with a growth rate of 19.1% p.a. for the GDP.

Both the current Financial Secretary and his predecessor have remarked on the desirability of curbing the growth of government expenditure. For example, in his 1981-82 Budget Sir Philip Haddon-Cave said: "Defined in the usual way, the relative size of the public sector in Hong Kong has increased from 16.2% in 1975 to 21.2% in 1980 and will increase further to 22.4% in 1981. There can be no question of the public sector being allowed to command an ever-increasing proportion of the community's resources in the 1980s, for the direct consequence of that would be that the private sector would be less able to cope with rapid changes in the world economic environment..... (But) the allocation of resources between the public and private sectors ... will have to be vigorously debated in the 1980s as in the 1970s." (para 298)

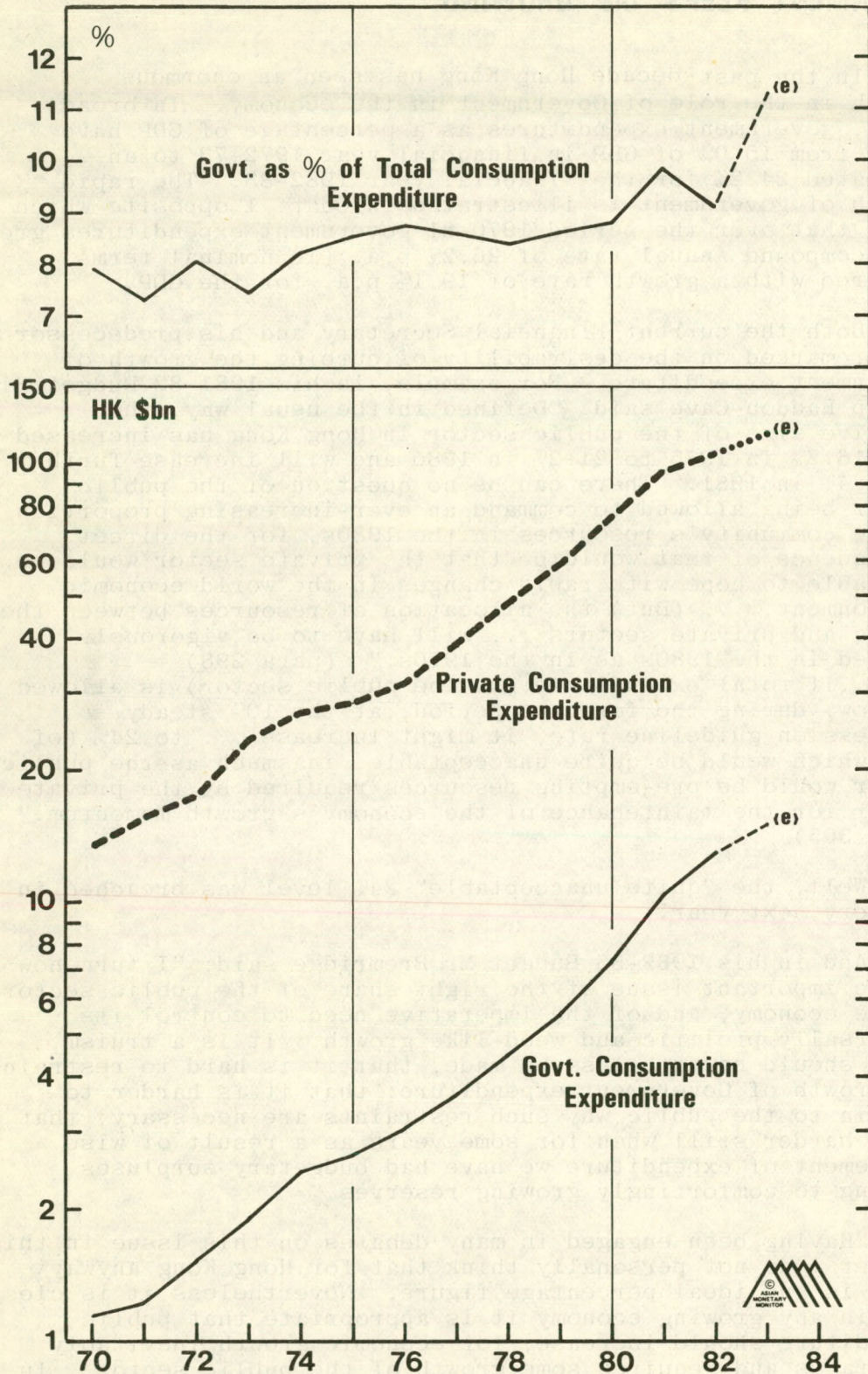
".....if total expenditure (in the public sector) is allowed to grow, during the forecast period, at the 10% steady progression guideline rate, it might increase ... to 24% (of GDP) which would be quite unacceptable, inasmuch as the public sector would be pre-empting resources required by the private sector for the maintenance of the economy's growth momentum." (para 305)

Well, the "quite unacceptable" 24% level was breached in the very next year!

And in his 1982-83 Budget Mr. Bremridge said: "I turn now to the important issue of the right share of the public sector in the economy, and of the imperative need to control its universally prolific and weed-like growth. It is a truism, which should nevertheless be made, that it is hard to restrain the growth of Government expenditure; that it is harder to explain to the public why such restraints are necessary; that it is harder still when for some years as a result of wise management of expenditure we have had budgetary surpluses leading to comfortably growing reserves."

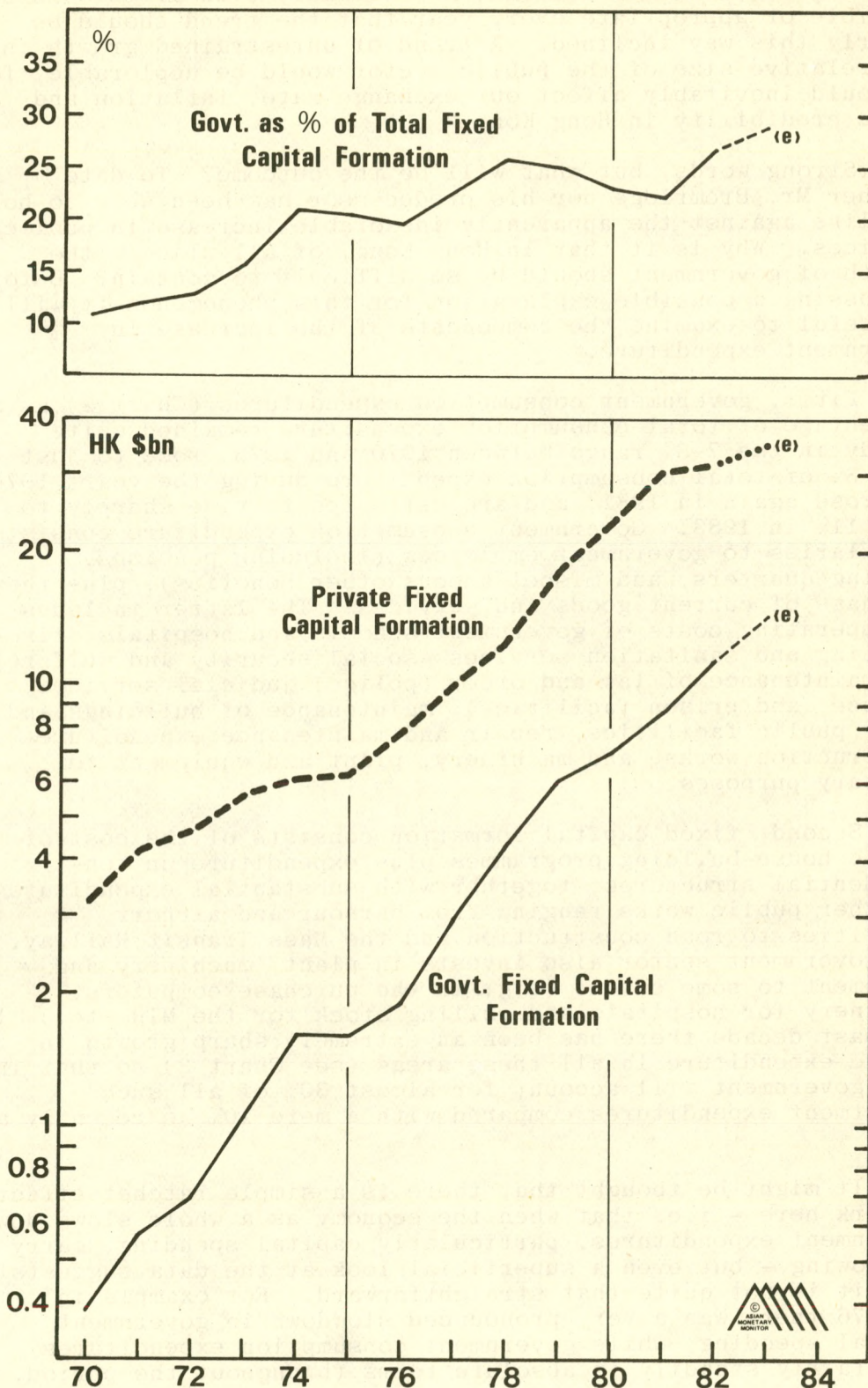
"Having been engaged in many debates on this issue in this Chamber I do not personally think that for Hong Kong anyway there is any ideal percentage figure. Nevertheless it is clear that in any growing economy it is appropriate that public expenditure should increase, for economic growth inevitably encourages and requires some growth of the public sector. In

HONG KONG : CHART 2
THE GROWTH OF GOVERNMENT CONSUMPTION



HONG KONG : CHART 3

THE GROWTH OF GOVERNMENT INVESTMENT



Hong Kong I believe strongly that for the future firstly we should try to keep this growth rate in public expenditure down to the growth rate of the GDP, and secondly even if this is not feasible or appropriate every year that the trend should be clearly this way inclined. A trend of unrestrained growth in the relative size of the public sector would be deplorable, for it would inevitably affect our exchange rate, inflation and basic credibility in Hong Kong."

Strong words, but what will be the outcome? To date neither Mr. Bremridge nor his predecessor has been able to hold the line against the apparently inexorable increase in public services. Why is it that in Hong Kong, of all places, the growth of government should be so difficult to contain? Before discussing a possible explanation for this phenomenon it will be useful to examine the components of the increase in government expenditure.

First, government consumption expenditures (Chart 2) as a percentage of total consumption expenditure remained quite steady in the 7-8% range between 1970 and 1973, rose to just over 8% of total consumption expenditure during the years 1974-80, rose again in 1981, and are estimated to rise sharply to over 11% in 1983. Government consumption expenditure consists of salaries to government employees (including pensions, housing quarters, and miscellaneous other benefits), plus the purchase of current goods and services. The latter includes the operating costs of government schools and hospitals; fire-fighting and sanitation services; social security and welfare; the maintenance of law and order (police, judicial services, defence, and prison facilities); maintenance of buildings and other public facilities, repair and maintenance expenditures on construction works, and machinery, plant and equipment for military purposes.

Second, fixed capital formation consists of the cost of public house-building programmes plus expenditure on non-residential structures, together with substantial expenditures on other public works ranging from harbour and airport facilities to road construction and the Mass Transit Railway. The government sector also invests in plant, machinery and equipment to some extent (e.g. in the purchase computers, machinery for hospitals and rolling stock for the MTR etc.) In the past decade there has been an extremely sharp growth in public expenditure in all these areas (see Chart 3) so that in 1983 government will account for almost 30% of all such investment expenditures compared with a mere 10% as recently as 1970.

It might be thought that there is a simple ratchet-effect at work here - i.e. that when the economy as a whole slows down government expenditures, particularly capital spending, carry on growing - but even a superficial look at the data suggests that it is not quite that straightforward. For example in 1975-76 there was a very pronounced slowdown in government capital spending, while government consumption expenditures rose fairly steadily in absolute terms throughout the period.

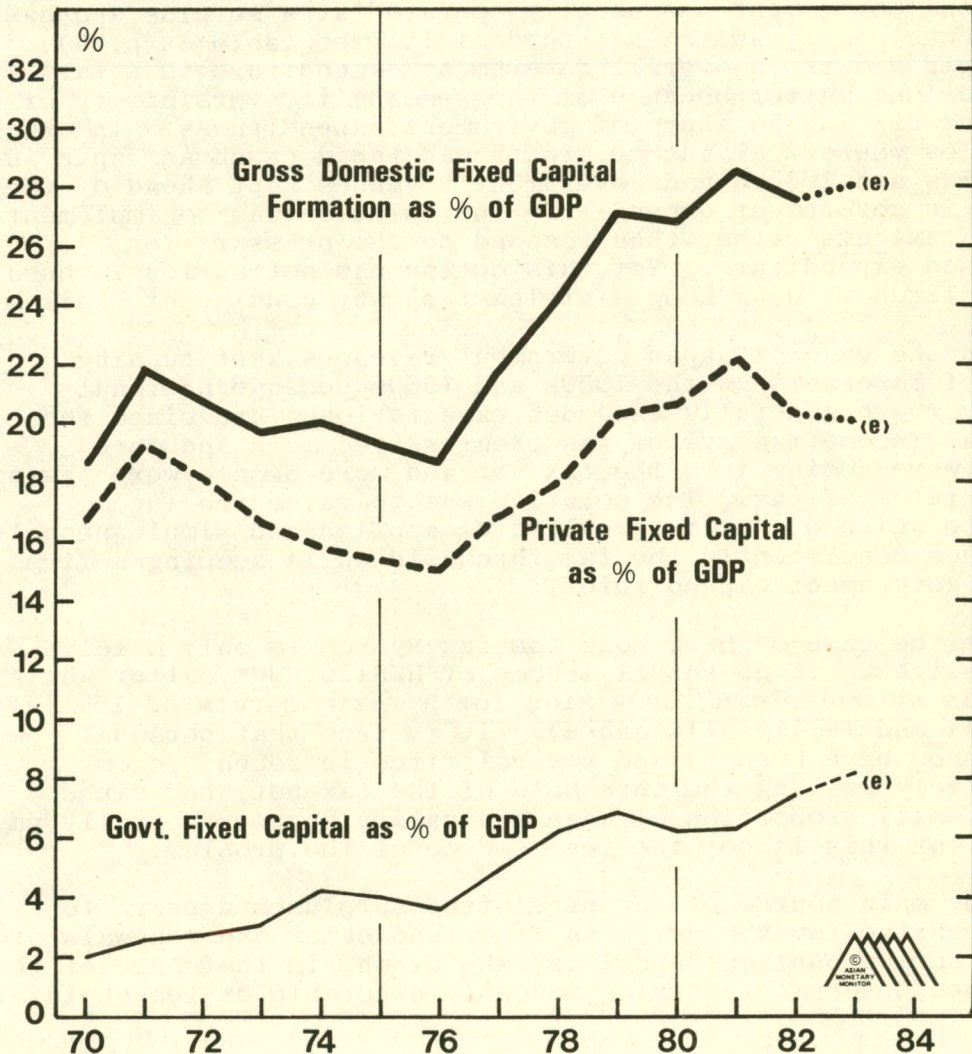
HONG KONG GOVERNMENT REVENUE AND EXPENDITURE

(HK\$Mn)	Revenue			Expenditure			Overall Surplus/Deficit	Surplus/Deficit as % of GDP
	Recurrent	Capital	Total	Recurrent	Capital	Total		
1973-74	4550	466	5016	3231	1411	4642	374	1.10
1974-75	5156	437	5593	4175	1796	5971	-378	-0.97
1975-76	5843	412	6255	4450	1573	6023	232	0.57
1976-77	6850	644	7494	5224	1353	6577	917	1.76
1977-78	8151	1232	9383	6219	1939	8158	1225	2.05
1978-79	10146	2296	12442	7308	3648	10956	1486	2.14
1979-80	13473	3323	16796	8865	4956	13821	2975	3.33
1980-81	18951	11236	30187	11919	7756	19675	10512	9.30
1981-82	24014	9480	33494	16295	10500	26795	6699	4.88
1982-83	25210	5608	30818	20799	13954	34753	-3935	-2.50
1983-84*	28693	3577	32270	23808	11629	35437	-3167	-1.79

*Proposed

HONG KONG : CHART 4

COMPOSITION OF GROSS DOMESTIC FIXED CAPITAL FORMATION



It would seem that in general government expenditures tend to rise more rapidly in the late stages of a business cycle upswing. This could be because as the business cycle picks up, government revenues also tend to rise quite sharply, giving government very substantial surpluses. A major element in the pro-cyclical behaviour of government revenues is the Hong Kong Government's traditional dependence on land sales. The fact that government revenues are flush when the business cycle is still strong encourages government to expand its programmes faster than the growth in the private sector as a whole. Capital expenditure expansion by government will often be accompanied by parallel increases in consumption expenditures because additional staff are required for new projects etc. and inevitably these servicing costs are more in the nature of fixed expenses. When the downturn comes it is more difficult to cut back on consumption-type expenditures than it is to reduce ambitious capital projects to more manageable proportions with the result that capital expenditures experience wider volatility, but consumption expenditures are much more likely to carry on growing.

While it is easy to make a virtue out of the fact that the Hong Kong Government has usually operated at a surplus and has only occasionally switched into deficit (see table on p.15), the rapid growth in overall government expenditure is a far more serious matter because of the seeming irreversibility of the increase in the share of government expenditures. In other countries where real income growth was rapid (such as Japan in the 1950s and 1960s) and government revenues kept ahead of the growth in government expenditure the solution was to implement annual tax cuts rather than respond to the pressure for increased expenditure. Yet this option has not seriously been contemplated in Hong Kong - at least on any consistent basis.

In the case of Japan government revenues kept running ahead of forecasts in the 1950s and 1960s because national income growth generally exceeded expectations, and since the personal income tax system was progressive, more and more people were coming into the tax net and more people were paying higher rates of tax. The solution was to raise the income bands to which higher marginal rates applied and simultaneously to reduce consistently the tax threshold while keeping a firm lid on government expenditures.

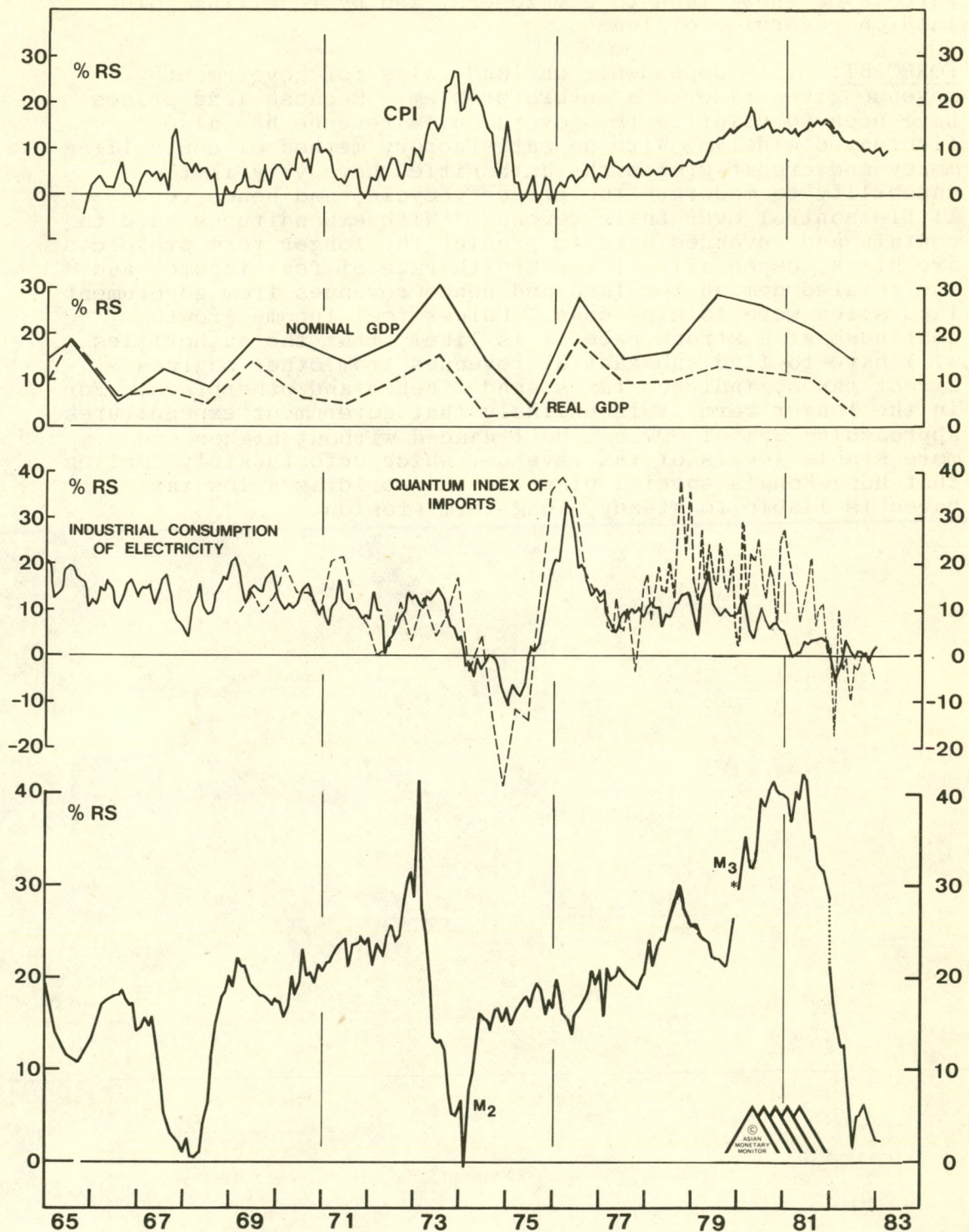
In the case of Hong Kong the tax system is only mildly progressive up to an annual income of HK\$120,000*, after which there is an overriding provision for a maximum rate of 15% (after personal and family allowances). It is true that personal allowances have been raised several times in recent years, effectively raising the threshold of the tax net, but since only a small proportion of wage and salary earners actually pay income tax this is not the real source of the problem.

The main source of the persistent surpluses appears to have been the revenue deriving from land sales and renewals of leases during business upswings, the Crown (in the shape of the Hong Kong Government) having monopoly ownership or leasehold of

* For a single person; for a married person with 2 children 15% is payable only after an annual income of HK\$223,750.

HONG KONG

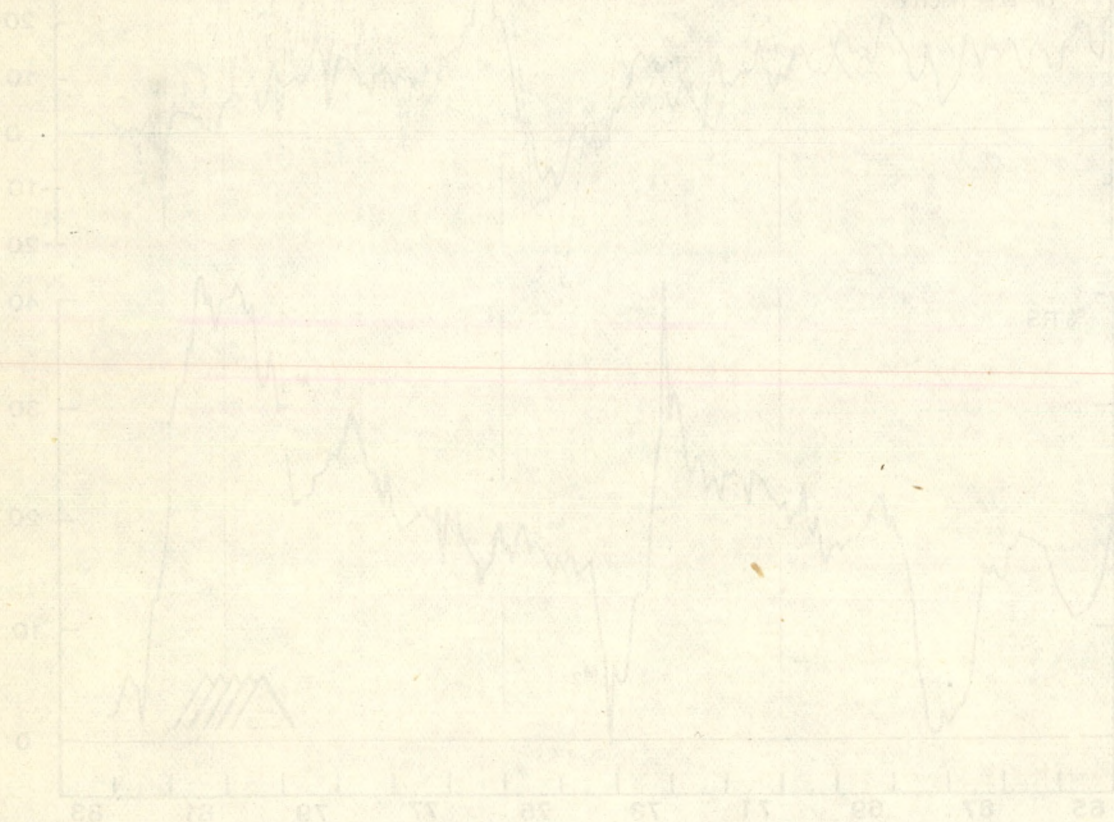
CHART 5 : MONEY, OUTPUT INDICATORS, AND PRICES



*CHANGE OF M₂ TO M₃ SERIES

virtually all land in the colony. The Government is therefore able to capitalise on rising real incomes by selling off parcels of "new" land to developers, and by reselling "old" land on reversion of leases.

FORECAST: This dependence on land sales for government revenue gives rise to a severe problem. Because land prices have been so volatile the government's revenue has also fluctuated widely. With no satisfactory method of controlling money and credit growth the authorities have very little capability to moderate the property cycle, and hence very little control over their revenue. With expenditures hard to contain and revenues hard to predict the longer term prospects are bleak, especially if the growth rate of real incomes and the related demand for land and hence revenues from government land sales were to slow down. Unless real income growth continues at a strong pace it is likely that the authorities will have to find substantial revenues from other sources - direct taxes, indirect taxes, and licence and other fees. For in the longer term it is unlikely that government expenditures approaching 25% of GDP can be financed without higher and more stable levels of tax revenue, which unfortunately implies that Hong Kong's special place in the world as a low tax haven is liable to steady, long-term erosion.



JAPAN

WHY THE YEN IS LIKELY TO CONTINUE TO BE STRONG

Since the end of October there has been a remarkable reversal in the fortunes of the yen. After depreciating nearly 27% against the US dollar during the first ten months of 1982, the yen subsequently strengthened from ¥278.5 to around ¥235 at the time of writing. The yen's rise against the US currency does not merely reflect dollar weakness. The yen has appreciated by roughly 10% against the E.M.S. currencies and by more than 15% against the pound-sterling.

The US dollar's strength since June 1980 - which was only briefly interrupted during the final four months of 1981 - was based on three fundamental developments. First, throughout this period the US authorities persisted with a restrictive monetary policy. Second, the current account of the balance of payments continued in surplus. Lastly, foreign Central Banks increasingly responded to weakness in their domestic economies by pursuing more accommodative monetary policies.

The restrictive monetary policy practised by the Federal Reserve throughout the October 1979 - September 1982 period was explicitly designed to reduce substantially inflation in the US economy. Thus the Federal Reserve persisted with its restrictive stance into 1982, even though inflation had already declined from a cyclical high of 14.6% in March 1980 to 8.8% at the end of 1981, and in spite of the worsening recession evident in the early months of last year. The prolonged period of monetary restraint was a key element in the bull market for the dollar. Chart 1 illustrates the trend in the dollar's effective exchange rate relative to the actual and targeted growth in M1, and the level of the Federal Funds rate since the start of 1980. Three features are immediately apparent from Chart 1. First, throughout the bulk of the period under review monetary growth was above target. The Federal Reserve's response to this was to ration the supply of reserves to the US banking system. The Federal Funds rate is the price of marginal reserve transactions. Thus, a rising Federal Funds rate was one symptom of above target monetary growth. Second, it is clear that the Federal Funds rate only declined when monetary growth fell within its target band. Third, falling short term interest rates had, typically, only a transitory impact on the dollar's strength during the October 1979 - September 1982 period. Falling short term interest rates were an indication of a successful monetary policy and not a precursor of an "easier" stance. In other words, falling short term interest rates signalled a continuation of the "tight" monetary policy which proved so favourable for the dollar.

The trend in the US current account improved significantly during 1979 and surpluses were maintained, in aggregate, throughout 1980, 1981 and the first half of 1982. Chart 2 depicts the relationship between the US current account,

Japan: Chart 1

The Dollar's Effective Exchange Rate, Federal Funds Rate and Monetary Growth

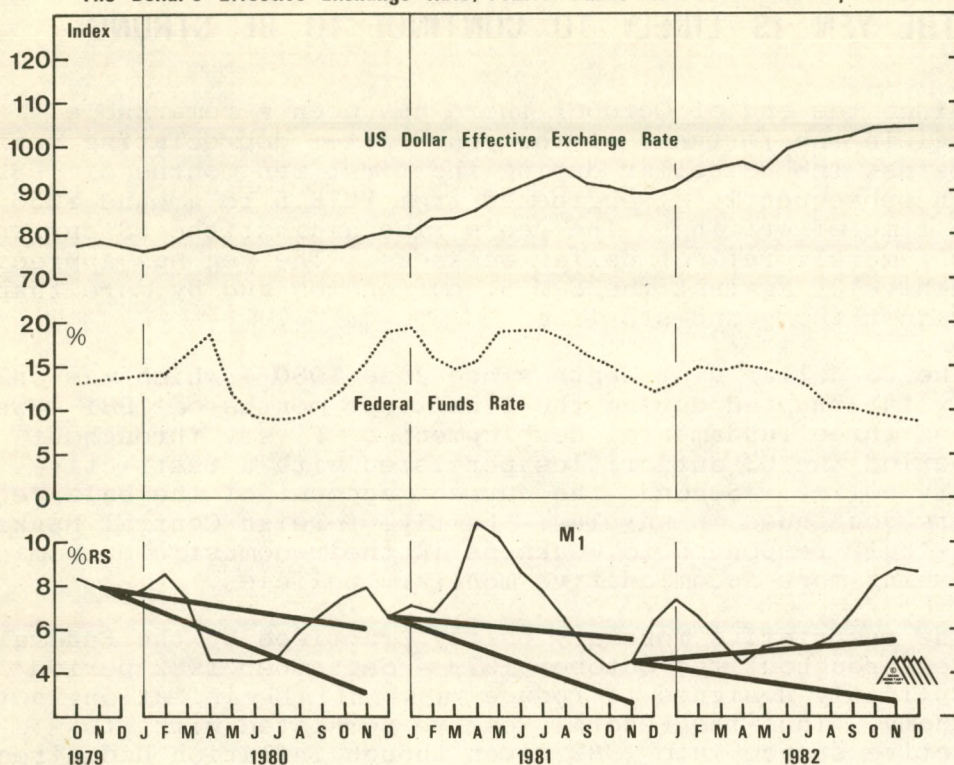


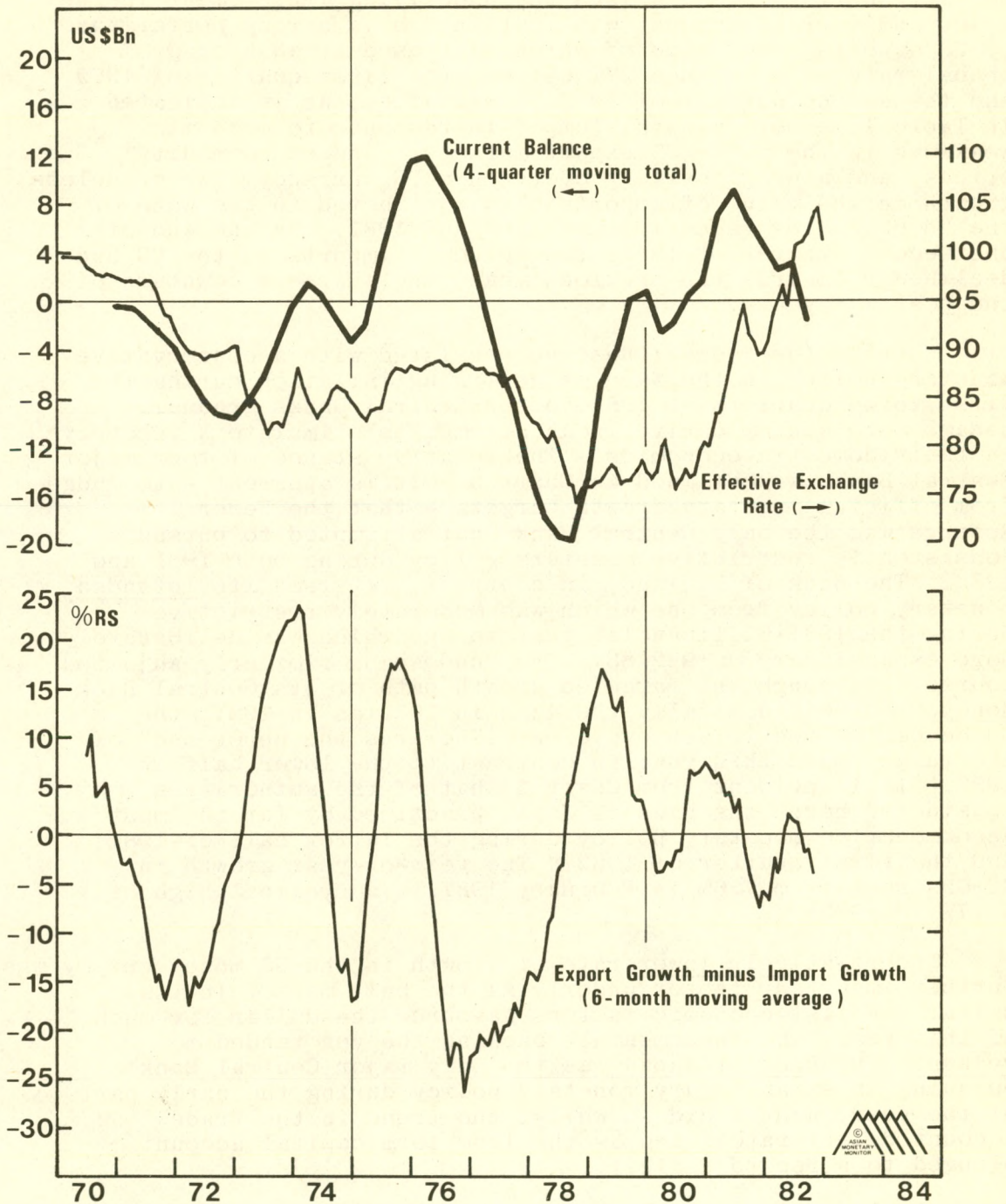
Table 1

Basic Trends in the US External Account

Period		Current Account surplus US\$ Mn	Import Growth % RS	Export Growth % RS
1979	Q I	1408	11.9	32.7
	Q II	-1493	15.7	19.9
	Q III	1052	22.4	26.6
	Q IV	-189	27.3	27.8
1980	Q I	-2095	35.1	29.1
	Q II	-545	20.3	27.3
	Q III	3381	6.5	18.6
	Q IV	938	4.5	12.6
1981	Q I	3248	4.3	12.7
	Q II	1399	9.1	7.4
	Q III	751	11.3	4.1
	Q IV	-926	7.8	0.0
1982	Q I	1088	- 5.3	- 7.4
	Q II	2230	- 9.4	- 6.1
	Q III	-4230	- 1.6	- 8.9

Japan : Chart 2

US Current Account, Trend in the Trade Account and the Dollar's Effective Exchange Rate



the underlying trend in the US trade account and the effective exchange rate since the start of 1979. As has proved the case with other currencies, sustained current account surpluses were an important factor underpinning the bull market in the US dollar. During 1979 and 1980 the underlying improvement in the trade and current account was sustained by a strong performance by US exports, the value of which increased at an average annual rate of more than 27% between the first quarter of 1979 and the second quarter of 1980. Thereafter, as is indicated in Table 1, export growth slumped in response to economic weakness in the major US export markets, reduced commodity prices, and a progressively overvalued US currency. Nevertheless, growth in the value of imports also contracted in the wake of the "double dip" recessions of 1980 and 1981. By the end of the second quarter of 1982, the value of imports to the US had declined 9.4% from the previous year, the sharpest downturn of the post war years.

Whereas the Federal Reserve persisted with a conservative monetary policy in the face of declining inflation during the first three quarters of 1982, other Central Banks gradually became more accommodative in an attempt to stimulate a recovery in their domestic economies. The relative stance of four major Central Banks is outlined in Chart 3. It is apparent - to judge from official monetary growth targets - that the Federal Reserve was the only Central Bank that attempted to pursue a consistently restrictive monetary policy during both 1981 and 1982. The Bank of England, in contrast, reversed its intended monetary policy from one which was moderately restrictive during the 1981-82 financial year to one which was deliberately more expansionary in 1982-83. The Bundesbank similarly adjusted course. Although the targeted growth path of its Central Bank Money Stock was nominally the same in 1982 as in 1981, the Bundesbank aimed to achieve growth "towards the upper end" of the target band this year in contrast to the lower half in 1982. It is evident from Chart 3 that of the authorities considered here, the Bank of Japan practised by far the most accommodative monetary policy during the latter half of 1981 and the first quarter of 1982. The year-on-year growth in M2+CDs rose from 7.6% in February 1981 to a cyclical high of 10.7% in 1982*.

The relatively lower rate of growth in the US money supply was a further important factor underlying the bull market in the dollar. Whilst economic factors favoured the dollar for much of this year, the fundamentals backing the yen tended to weaken. The Bank of Japan was the only major Central Bank pursuing an expansionary monetary policy during the early part of the year, and it did so whilst the trend in the trade account deteriorated, and as the long term capital account plunged to a record deficit.

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* The article "Why the Consensus Forecast for the Yen Will Prove Mistaken", AMM Vol. 6 No. 1 highlighted this as an important reason for expecting a weaker yen during 1982.

JAPAN : CHART 3 INTERNATIONAL TRENDS IN MONETARY GROWTH

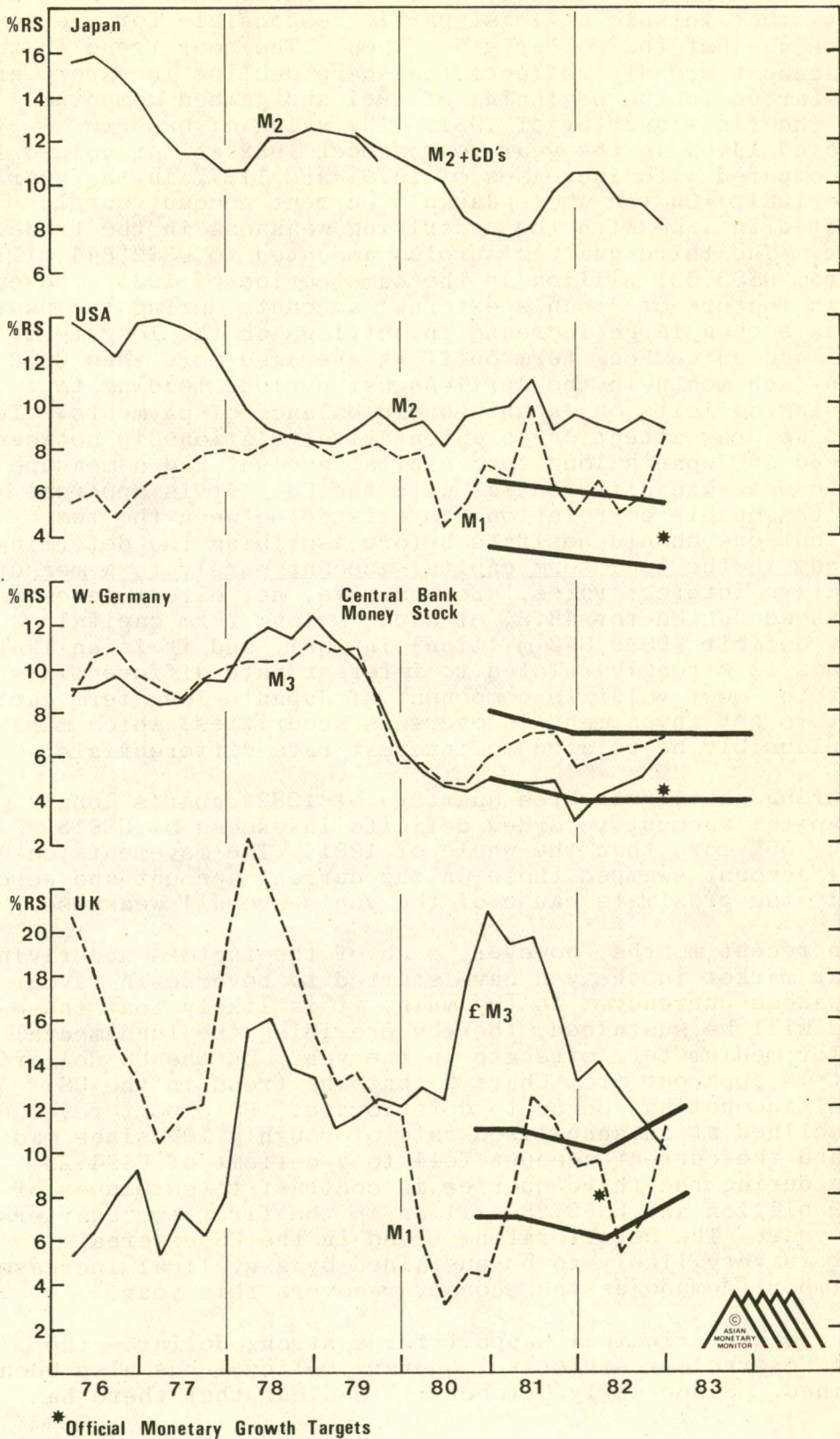


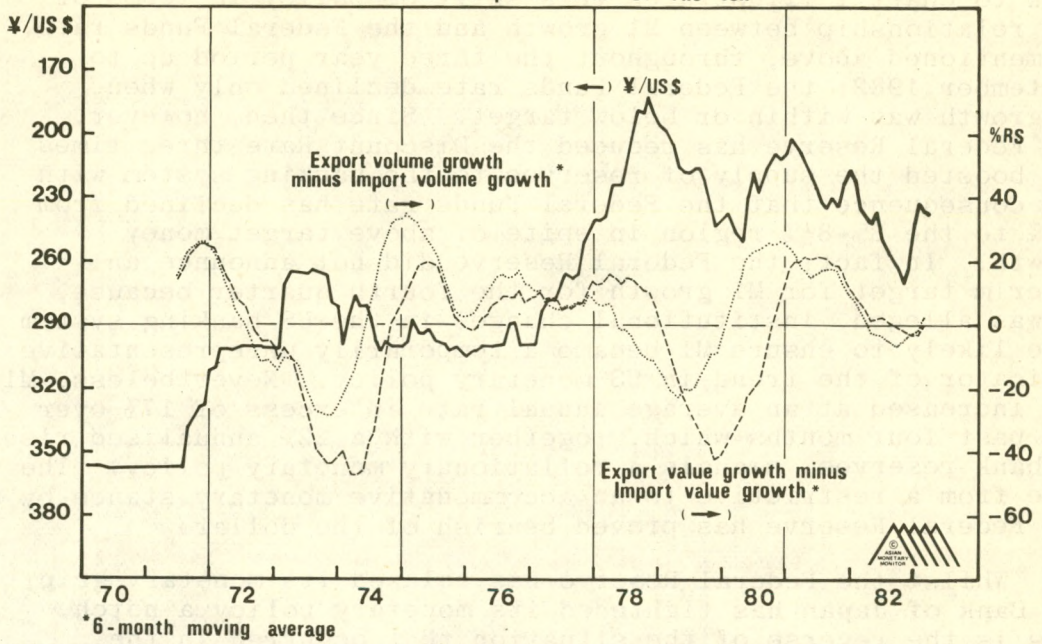
Chart 4 exhibits how the underlying trend in Japan's trade account has weakened steadily since the first half of 1981 and suggests that this is at least partly responsible for the yen's weakness against the dollar since then. The poor trend in the trade account broadly reflects the sharp decline in export growth, which started in the beginning of 1981 and gained momentum during the final quarter of 1981. The value of exports contracted 14.0% in the year to November 1982 whilst volume fell 2.8%, compared with increases of 15.9% and 11.7% in the year to June 1981. On the whole, Japan's current account surplus contracted in line with the underlying weakness in the trade account. The third quarter surplus amounted to US\$2,844 million, down from US\$3,531 million in the same period of 1981. However, the main feature of Japan's external accounts during the past year has been a large increase in outflows on the long term capital account. Long term outflows averaged more than US\$2 billion each month in the April-August period, leading to increasing deficits on Japan's basic balance of payments. In Chart 5 we draw attention to a tentative relationship between the trend in Japan's long term capital account and a measure of the interest rate differential with the US. It is apparent that a reasonable correlation has existed between the two series but one should hesitate before ascribing the determination of trends in the long term capital account purely to a measure of relative interest rates. For example, net direct investment overseas accounted for 48.6% of Japan's long term capital account deficit (US\$9,672 million) in 1981, and it is unlikely that this is strongly related to interest rate differentials. However the most volatile component of Japan's long term capital account is net investment in overseas securities, which may quite plausibly be related to interest rate differentials.

During the first three quarters of 1982 Japan's long term capital account recorded deficits in excess of US\$15 billion, 55% more than the whole of 1981. The movements on capital account swamped those on the current account and were arguably the proximate cause of the yen's overall weakness.

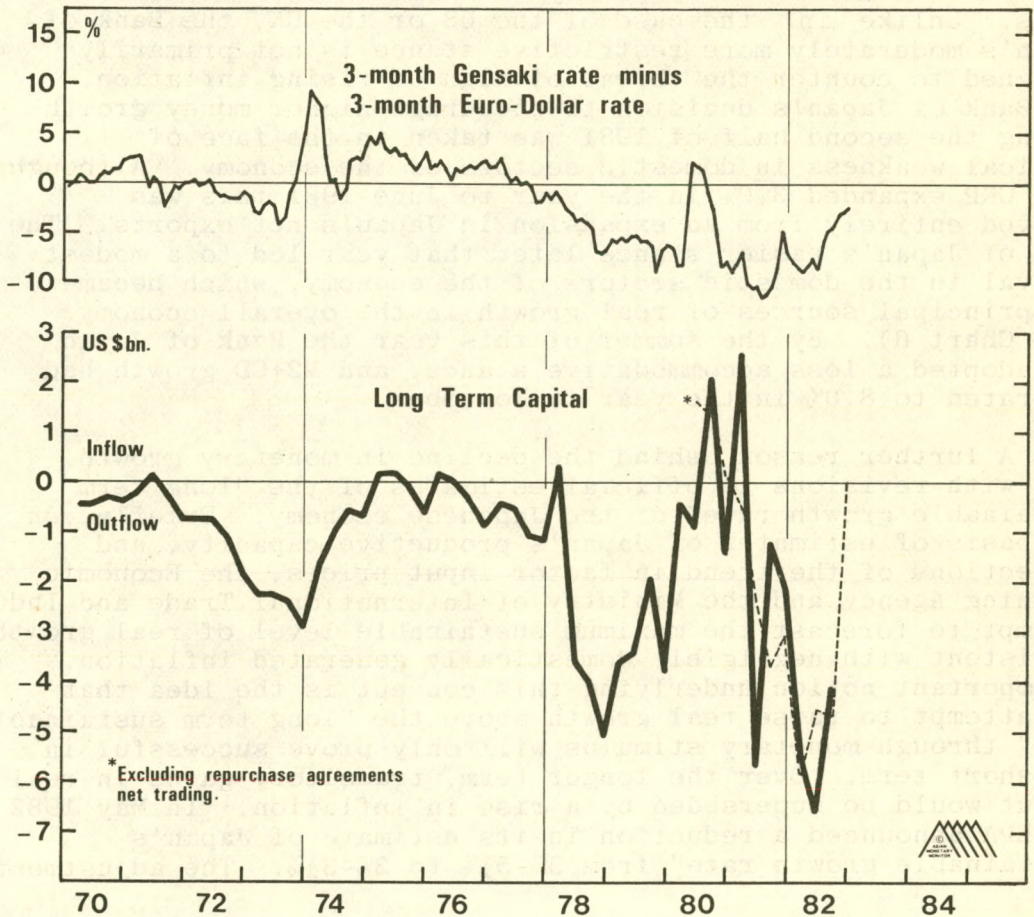
In recent months, however, each of the factors underlying the bear market in the yen have started to reverse in favour of the Japanese currency. In the main, it is likely that these changes will be sustained, thereby providing the fundamental basis for medium term strength in the yen. On the US dollar's side it is apparent from Chart 2 that the trend in the US external account has begun to deteriorate. US export revenues have declined at an annualised rate of roughly 10% since mid 1982, and the current account fell to a deficit of US\$4.23 billion during the third quarter in contrast to surpluses of US\$1.09 billion and US\$2.23 billion in the first two quarters of the year. The deteriorating trend in the US external account is very likely to be sustained by a cyclical increase in US import demand as the economy recovers this year.

The other principal support for a strong dollar - the Federal Reserve's restrictive monetary policy - has also been undermined. Since early October it is clear that there has

Japan : Chart 4
Proxies For Overall Competitiveness Of The Yen



Japan : Chart 5
The Long Term Capital Account and Interest Rate Differentials

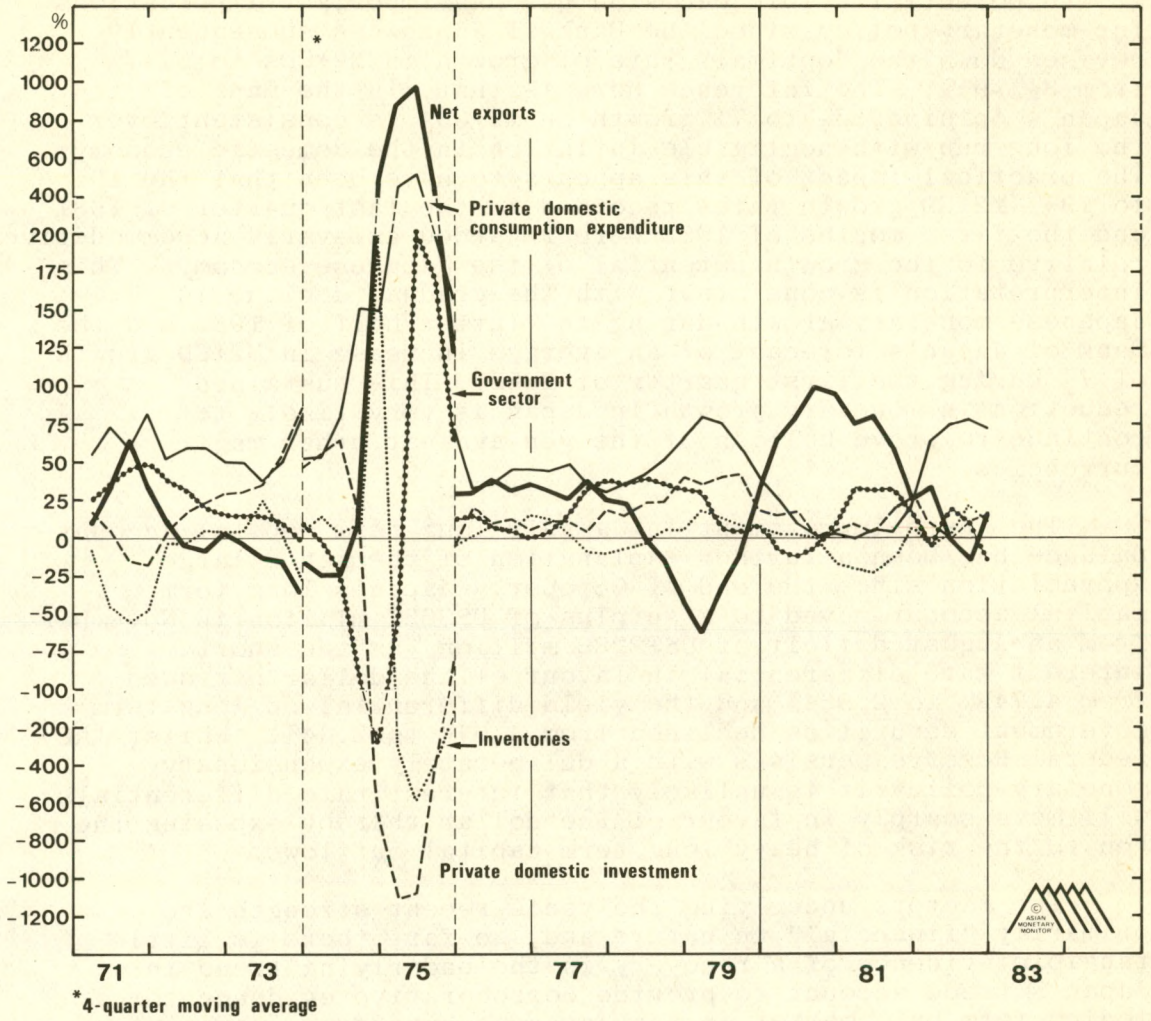


been an important adjustment in US monetary policy. A glance back to Chart 1 illustrates this shift of policy in terms of the relationship between M1 growth and the Federal Funds rate. As mentioned above, throughout the three year period up to September 1982, the Federal Funds rate declined only when M1 growth was within or below target. Since then, however, the Federal Reserve has reduced the Discount Rate three times and boosted the supply of reserves to the banking system with the consequence that the Federal Funds rate has declined from 10½% to the 8%-8½% region in spite of above target money growth. In fact, the Federal Reserve did not announce an interim target for M1 growth for the fourth quarter because, it was alleged, institutional changes in the US banking system were likely to ensure M1 became a temporarily unrepresentative indicator of the trend in US monetary policy. Nevertheless, M1 has increased at an average annual rate in excess of 17% over the past four months which, together with a 22% annualised rise in bank reserves, signals a reflationary monetary policy. The move from a restrictive to an accommodative monetary stance by the Federal Reserve has proved bearish of the dollar.

Whilst the Federal Reserve has relaxed its monetary grip, the Bank of Japan has tightened its monetary policy a notch. This is the reverse of the situation that occurred in the latter half of 1981 and the first months of 1982 Chart 3 indicates that the Bank of Japan is now pursuing a moderately more restrictive monetary policy than other major Central Banks. Unlike in the case of the US or the UK, the Bank of Japan's moderately more restrictive stance is not primarily designed to counter the threat of high or rising inflation. The Bank of Japan's decision to encourage higher money growth during the second half of 1981 was taken in the face of cyclical weakness in domestic sectors of the economy. Although real GNP expanded 3.9% in the year to June 1981 this was derived entirely from an expansion in Japan's net exports. The Bank of Japan's easier stance later that year led to a modest revival in the domestic sectors of the economy, which became the principal sources of real growth in the overall economy (see Chart 6). By the summer of this year the Bank of Japan had adopted a less accommodative stance, and M2+CD growth had moderated to 8.0% in the year to November.

A further reason behind the decline in monetary growth lies with revisions to official estimates of the "long term sustainable growth rate" of the Japanese economy. Briefly, on the basis of estimates of Japan's productive capacity, and projections of the trend in factor input prices, the Economic Planning Agency and the Ministry of International Trade and Industry attempt to forecast the maximum sustainable level of real growth consistent with negligible domestically generated inflation. An important notion underlying this concept is the idea that any attempt to raise real growth above the "long term sustainable rate" through monetary stimulus will only prove successful in the short term. Over the longer term, transitory gains in real output would be superseded by a rise in inflation. In May 1982 the EPA announced a reduction in its estimate of Japan's "sustainable growth rate" from 5%-5½% to 3%-3½%. The adjustment

JAPAN
Chart 6: Sectoral Contribution to Real Growth



was made in the light of its assessment of the impact of higher (permanently higher, in their view) real oil prices on Japan's growth potential. This decision has had important implications for monetary policy since the Bank of Japan has subsequently revised down the "optimal" rate of growth in M2+CDs to 6%-7% from 8½%-9½%. The inference here is that, in the Bank of Japan's opinion, 6% to 7% growth in M2+CDs is consistent over the long run with negligible inflation in the domestic economy. The practical impact of this appears to have been that the 10% to 10½% M2+CD growth rates recorded in the last quarter of 1981 and the first months of 1982 were regarded as overly accommodative relative to the growth potential of the Japanese economy. This interpretation is consistent with the gradual decline in Japanese monetary growth during the latter half of 1982 and the Bank of Japan's forecast of an average increase in M2+CD growth of 7% during the first quarter of 1983. This sustained reduction in monetary growth in Japan is very likely to continue to prove bullish of the yen against other major currencies.

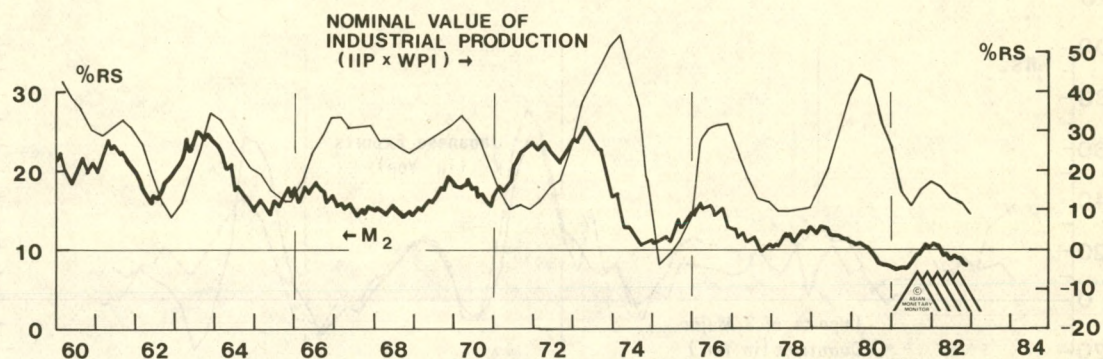
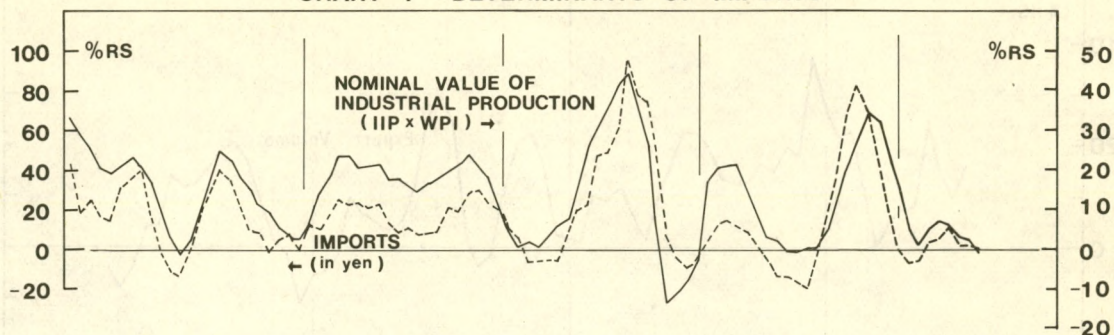
The sharp improvement in Japan's long term capital account balance has been a further explanation of the yen's large appreciation since the end of October. Japan's long term capital account moved to a surplus of US\$637 million in November from an August deficit of US\$2286 million, as the short interest rate differential in favour of the dollar narrowed from 4.742% to 2.964% and the yield differential on long term government securities declined from 4.67% to 2.44%. Whilst the Federal Reserve persists with a deliberately expansionary monetary policy it is unlikely that interest rate differentials will move sharply in favour of the dollar thereby exposing the yen to the risk of heavy long term capital outflows.

The factors underlying the yen's recent strength are primarily "financial" in nature and, so far, there is little tangible evidence of a recovery in the underlying trend in Japan's trade account to provide corroborative evidence for a medium term bull market in the Japanese currency. Japan's export performance, for example, appears to have deteriorated somewhat further during the final quarter of 1982 when the value of exports slid more than 15% from the fourth quarter of 1981. Nevertheless, there is good reason to expect an improvement in Japan's trade and current accounts this year.

Chart 7 models Japan's demand for imports in relation to monetary growth and the nominal value of industrial production, i.e. it basically ascribes changes in Japan's import demand to the strength or weakness of business activity in the domestic economy. It is clear from Chart 7 that the trend in monetary growth is a convincing lead indicator of the business cycle. On the basis of the recent course in Japan's monetary policy, and on the Bank of Japan's forecast for M2+CD growth for the first quarter of this year, there is little reason to anticipate a strong recovery in the domestic economy over the next six months. This in turn suggests that Japan's import demand is likely to remain slack during 1983. This conclusion would, of course, be strengthened in the event of a reduction in oil prices.

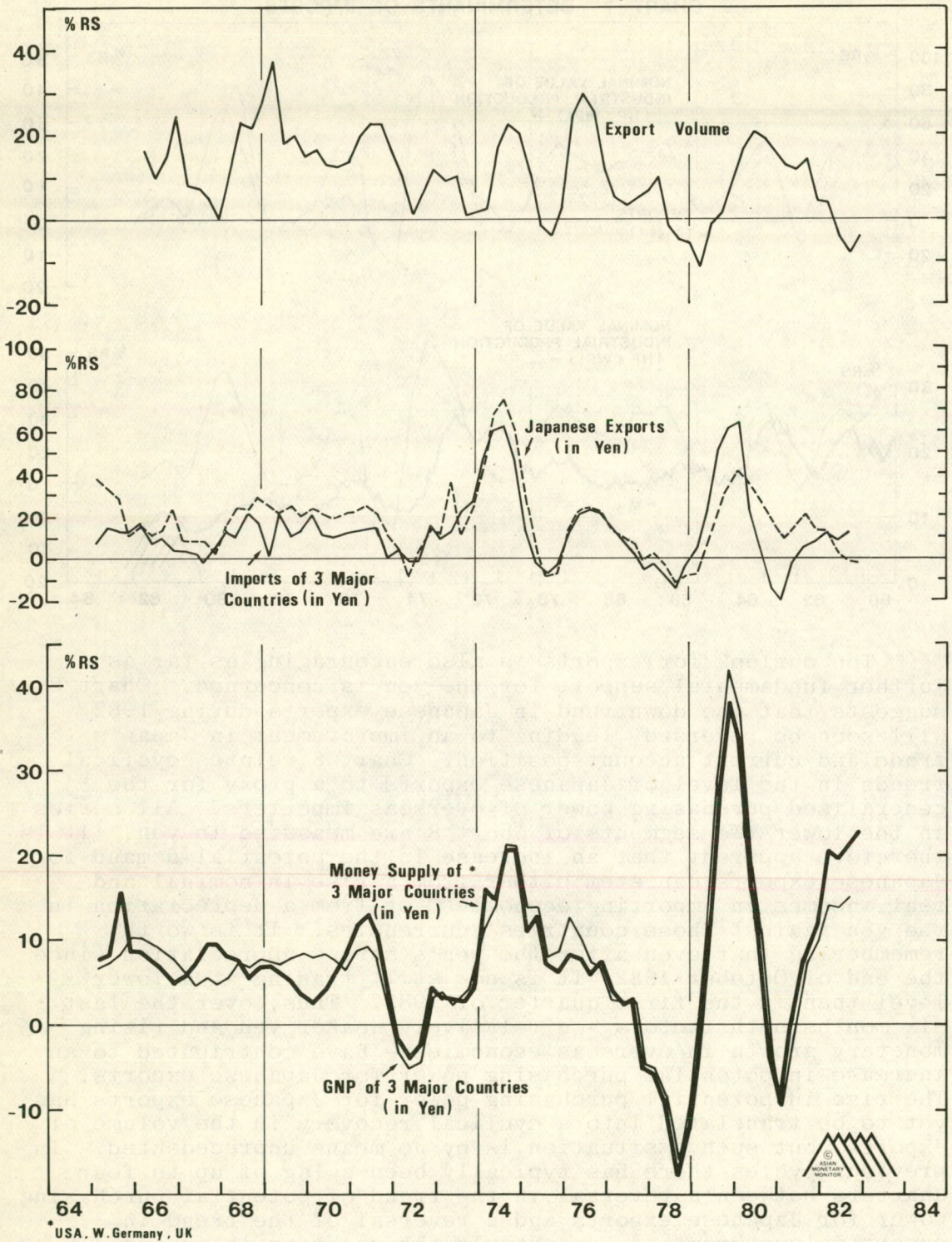
JAPAN

CHART 7 : DETERMINANTS OF IMPORTS



The outlook for exports is also encouraging as far as further fundamental support for the yen is concerned. Chart 8 suggests that the downtrend in Japanese exports during 1982 will soon be reversed, leading to an improvement in Japan's trade and current account position. Chart 8 relates cyclical trends in the level of Japanese exports to a proxy for the generalised purchasing power of overseas importers. All series in the lower two segments of Chart 8 are measured in yen. It is therefore apparent that an increase in the potential demand for Japanese exports can stem either from a rise in nominal and real incomes in importing economies, or from a depreciation in the yen against these countries' currencies. It is worth remembering that even after the yen's strong appreciation since the end of October 1982, it is now still trading at a lower level than in the first quarter of 1982. Thus, over the last six months both factors - a relatively weaker yen and rising monetary growth in overseas economies - have contributed to an increase in potential purchasing power for Japanese exports. The rise in potential purchasing power for Japanese exports has yet to be translated into a cyclical recovery in the volume of exports, but such a situation is by no means unprecedented. In previous cycles there has typically been a lag of up to four quarters between a reversal in the trend of potential purchasing power for Japanese exports and a reversal of the trend in export volume growth. For example the recovery in export volumes at the end of 1979 lagged the steep improvement in purchasing power for Japanese goods by fully three quarters. In this cycle the lag has been longer, reflecting the extended

JAPAN
Chart 8 : Determinants of Exports



recession in the US and Europe. Nevertheless, on the basis of Chart 8 it is reasonable to anticipate a recovery in Japan's exports this year in line with an improvement in economic conditions overseas.

FORECAST: The confluence of events outlined above is likely to sustain a further appreciation in the yen against other leading currencies. It is particularly important that the Bank of Japan is now pursuing a relatively more restrictive monetary policy than other Central Banks and that this has been maintained in spite of the change towards a more reflationary stance at the Federal Reserve. In the same way that the Federal Reserve's restrictive monetary policy during the October 1979 - September 1982 period provided fundamental support for bull market in the dollar so is the gradual slowdown in monetary growth in Japan - at a time when other Central Banks are in the process of "easing" - likely to provide a strong under current of support for the yen.

The same idea may be argued in a slightly different form. The adjustment to the relative restrictiveness of monetary policy in Japan compared with other countries is likely to be reflected in the comparative strength of their economies. From mid 1981 through the first nine months of 1982 Japan's economy was relatively much stronger than others which were beset by recessions associated with restrictive monetary and credit policies. The respective strength of these economies was mirrored in the trend of their trade and current accounts: Japan's trade account deteriorated during that period in striking contrast to the strong improvement evident in, for example, West Germany, and a continued current account surplus in the US. This relative position is now likely to change. If the Bank of Japan persists with its current monetary stance it is improbable that Japan will share, to the same degree, in the forthcoming recovery in the US and most European economies. One may therefore anticipate a reversal of the trend in Japan's trade account in comparison with that of the US. If the trade and current accounts improve as expected, then the broad features of Japan's economy this year will be reminiscent of 1977. Growth in the domestic economy, particularly in the investment and capital goods sectors, is unlikely to be strong but the economy as a whole could well benefit from a recovery in net exports. Under such circumstances, declines in the level of short term interest rates would only temporarily interrupt cyclical strength in the yen.

HONG KONG DOLLAR

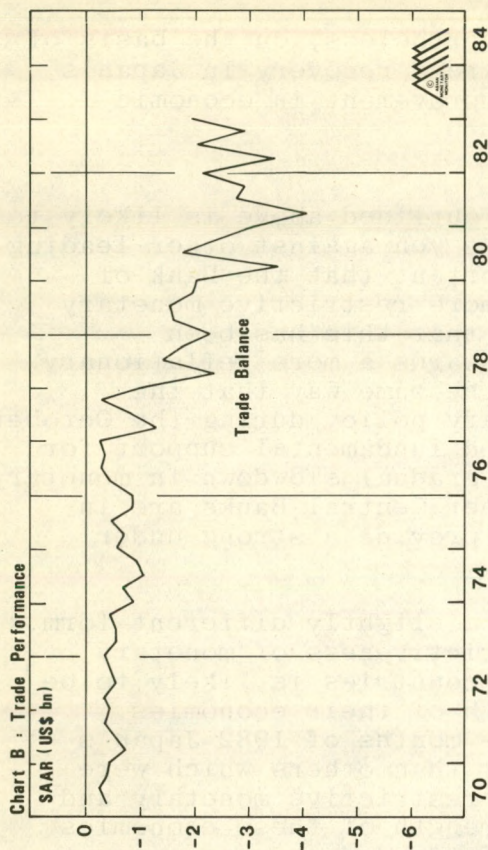
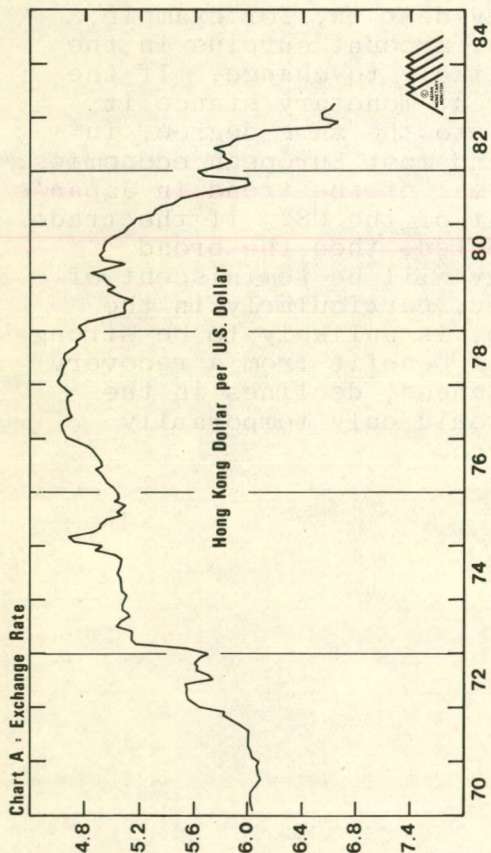
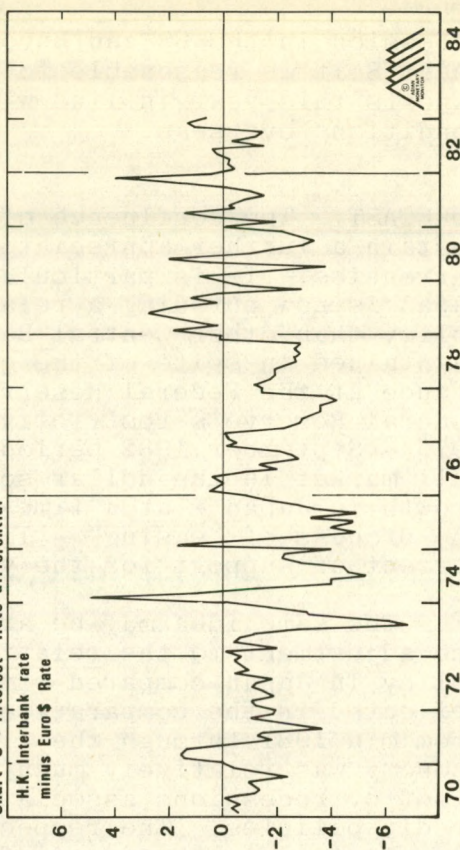


Chart C : Interest Rate differential



The Hong Kong dollar has weakened substantially against a majority of leading currencies since mid 1982. The Hong Kong dollar plunged from HK\$5.895 at the end of June to an all time low of HK\$6.95 on 26th October, 1982 before recovering to HK\$6.49 at the close of the year. Over the same period the Hong Kong dollar's trade weighted index declined 10.7% from 89.7 to 80.1.

Although the Hong Kong dollar has been on a weakening trend since 1979 (Chart A), its depreciation during the second half of 1982 occurred against the backdrop of a much improved set of economic fundamentals. The Hong Kong dollar's decline during 1980 and 1981 reflected an overheated domestic economy: monetary growth ballooned (Chart E), inflation surged and the trade account moved to a sizeable deficit (Chart B). Last year, however, these negative influences were progressively reversed. In particular, excessive monetary growth, which had been at the heart of the Hong Kong dollar weakness, was curbed and domestic liquidity contracted sharply. "Hong Kong dollar" M3 rose by a very modest 8.0% during 1982, down significantly from 36.2% growth recorded during 1981.

Currencies typically respond favourably to a highly restrictive

domestic monetary conditions. For example, the sustained monetary restraint practised by the US Federal Reserve up until September 1982 was an important factor underpinning the strength of the US dollar in the last two years. During the first months of 1982 the Hong Kong dollar performed in a similar manner. The Hong Kong dollar appreciated 6.2% against its trade weighted index in the six months to March 1982 as monetary growth slowed, inflation declined and the trade account (Chart B) began to improve.

Since each of these fundamental influences have continued to point to a broadly stronger Hong Kong dollar it is perfectly reasonable to ascribe its recent pronounced weakness to obvious anxieties associated with the political future of the Colony. It is worth emphasising, that throughout the period of greatest political uncertainty, fundamental support for the Hong Kong dollar was strengthening. For example, the two and a half percentage point decline in HKAB lending rates has occurred against a background of continued slow growth in the monetary aggregates.

The degree of uncertainty surrounding the political future of Hong Kong clearly exacerbates the problems of attempting to forecast medium term trends in the Hong Kong dollar. Nevertheless it is well worth noting (Chart D) that the Hong Kong dollar enjoys greater competitiveness now than at any stage since 1972. This is one reason why the trend in Hong Kong's trade account is likely to continue gradually improving, for it suggests that the local manufacturers are in a strong position to benefit from a recovery in the US and other important export markets. If a satisfactory resolution to the current political impasse is achieved there can be little doubt that the Hong Kong dollar would rise strongly on the foreign exchanges. In the meanwhile, favourable fundamental support for the Hong Kong dollar is likely to prevent further weakness against most major currencies.

HK\$/US\$	ACTUAL			FORECAST	
	1982 Q3	Q4	1983 Mar.-Jun.	Q3	Q3
FORECAST A					
Actual Range	5.84-6.29	6.33-6.95	6.45-6.65	6.30-6.50	
FORECAST B					
			6.45-6.75	6.65-6.95	

Forecast A assumes that the US Federal Reserve maintains its current reflationary monetary policy and that US short rates do not rise over the next six months.

Forecast B assumes that the US Federal Reserve restricts monetary growth to ensure further reductions in inflation, thereby leading to higher interest rates during the second quarter of 1983.

Chart D : Price Competitiveness (adjusted for exchange rate changes)

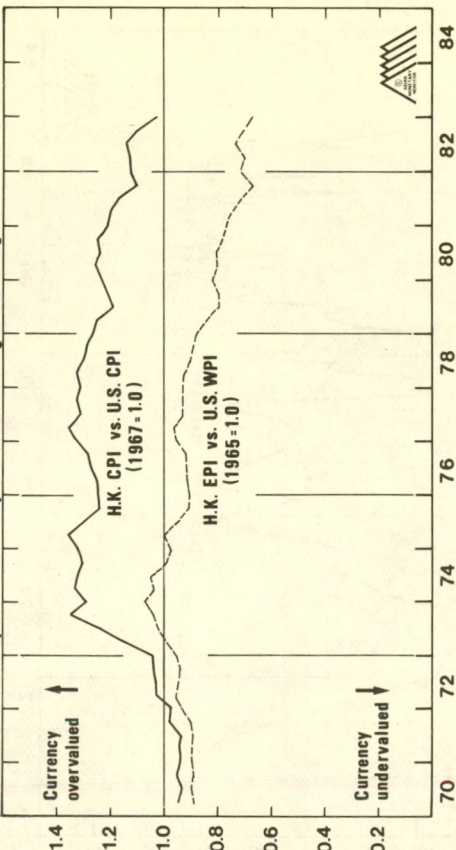
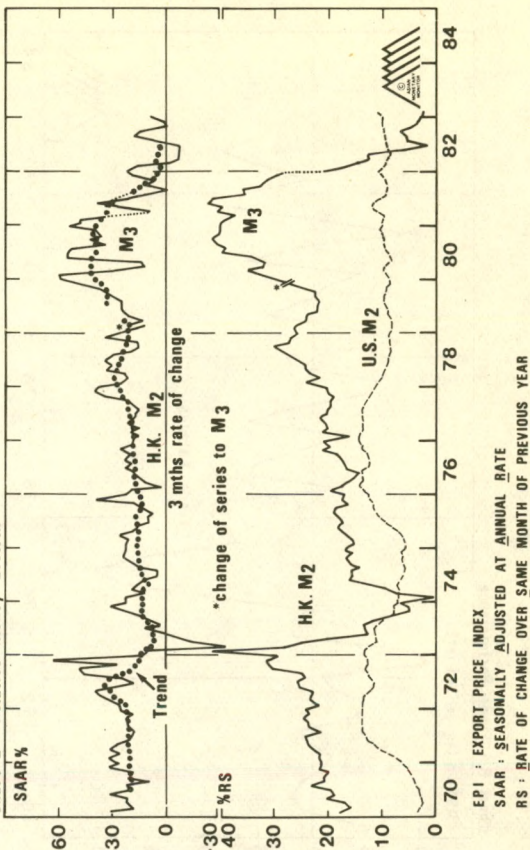


Chart E : Relative Money Growth



EPI : EXPORT PRICE INDEX
SAAR : SEASONALLY ADJUSTED AT ANNUAL RATE
RS : RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

NEW ZEALAND DOLLAR

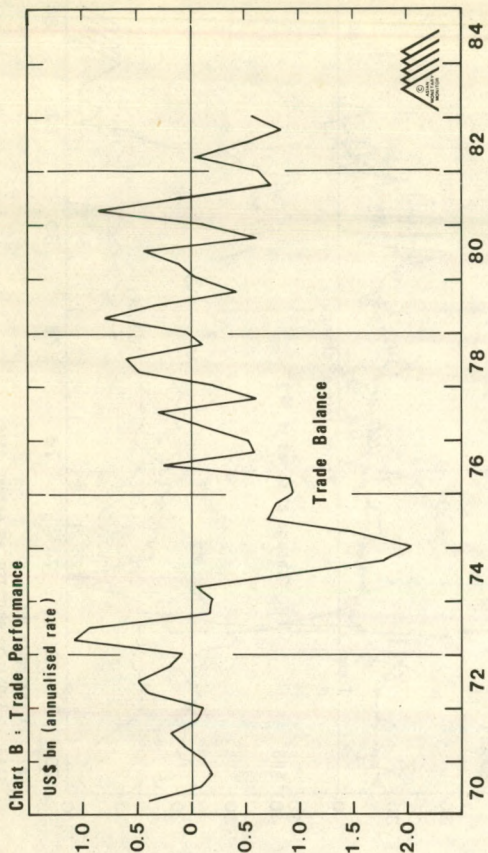
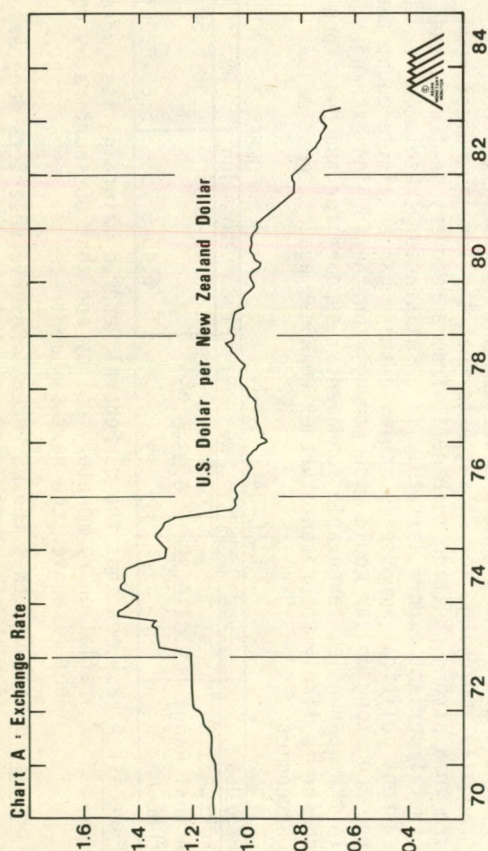
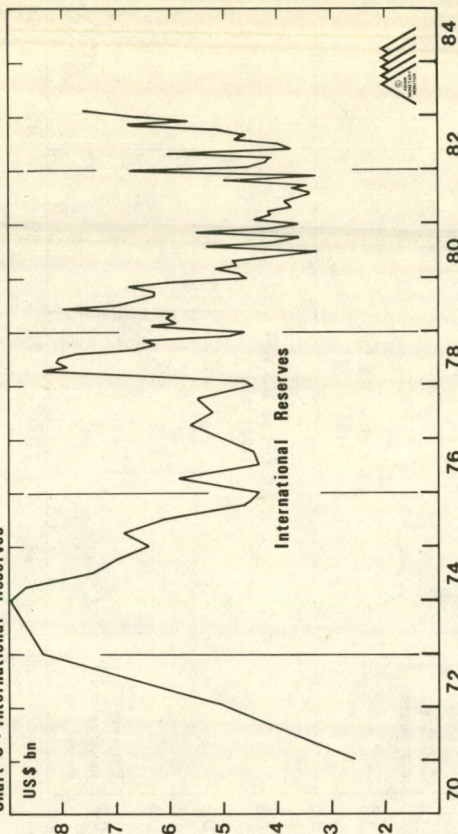


Chart C: International Reserves



The New Zealand dollar should be recognised as a fundamentally weak currency. The average annual rate of inflation in that country has exceeded 16% during the past four years. Thus although the New Zealand dollar has depreciated nearly 35% against its US counterpart since the end of 1978, it remains significantly overvalued (Chart D) on the basis of comparative price competitiveness.

During 1982 the New Zealand dollar depreciated 11.4% against a basically strong US dollar. An important contributory factor in this decline was the sizeable deterioration in New Zealand's balance of payments. The payments deficit widened to a record NZ\$2.152 billion in the year ended September 1982 from NZ\$1.143 billion a year earlier. Chart B illustrates how the larger balance of payments deficit is in part a consequence of the move to deficit on New Zealand's trade account. New Zealand's exports held up relatively well (up 14.0% in the year to September) in the face of declining world trade, but the value of imports soared some 28% during the first half of the year.

The strength of import demand reflected a modest upturn in the New Zealand economy in the early part of 1982. After sluggish growth in 1980 and 1981 the economy grew nearly 2% during the first half of

the year, following an easing of monetary policy (Chart E) late in 1981. The easier monetary stance at a time when the US Federal Reserve was pursuing a policy designed to ensure lower monetary growth was an important factor underlying the weakness of the New Zealand dollar at that time.

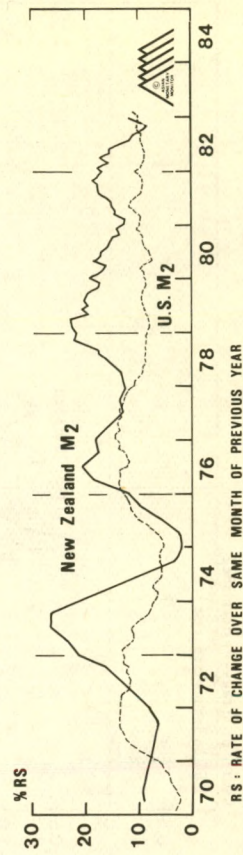
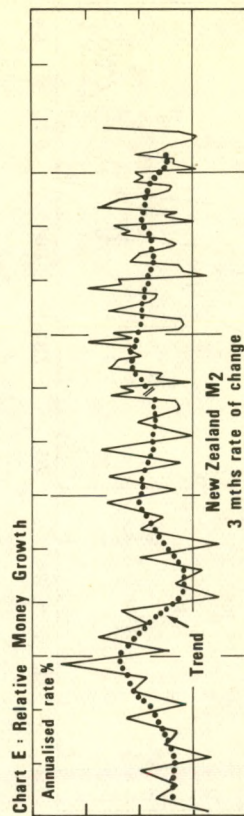
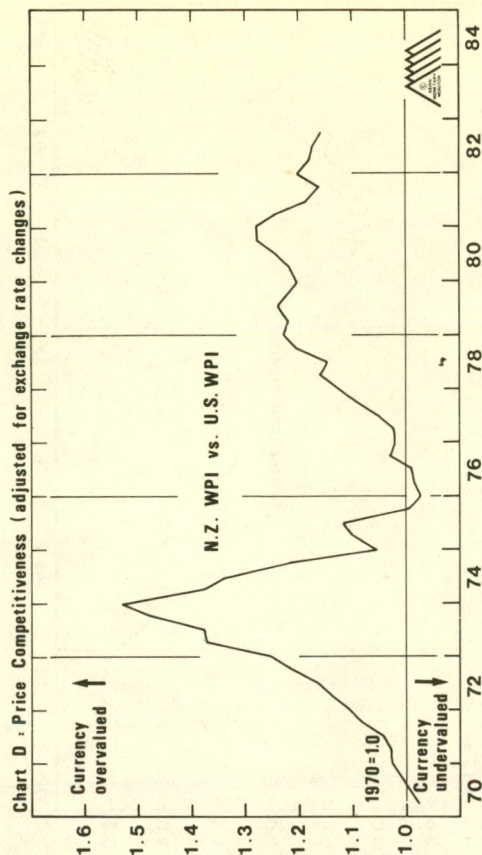
However the return to excessive monetary growth also sustained a continued high rate of inflation and it was only in mid 1982 that the New Zealand authorities made any serious effort to counteract this. In May, the Reserve Bank raised banks' minimum reserve requirements to 15% and simultaneously instructed banks and finance companies to curtail the growth in their lending. The yield on short dated commercial bills rose to a high of 18.5% and monetary growth began to decline sharply. By September 1982 the year-to-year growth in M3 had declined to 9.2% from 16.8% in the year to December 1981 and M1 growth fell to 2.7% from 15.3%.

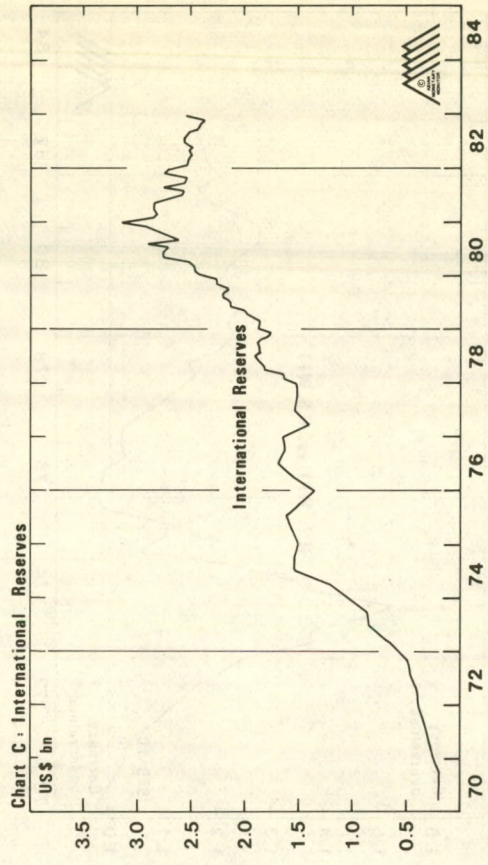
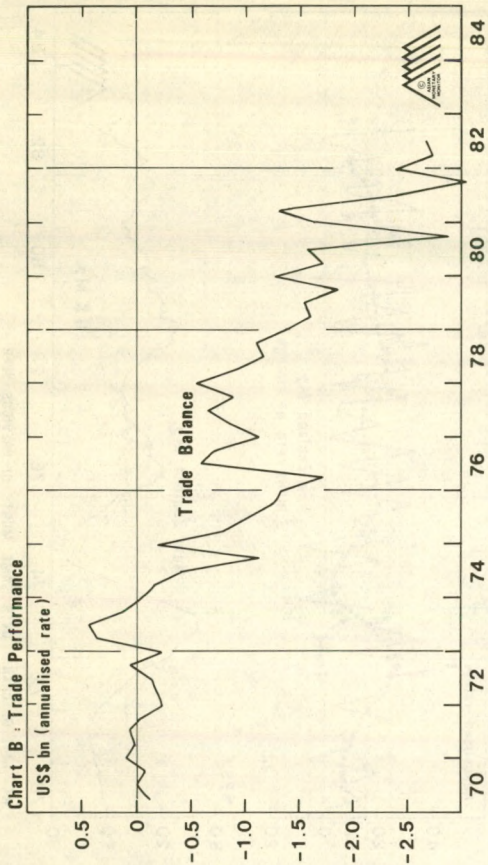
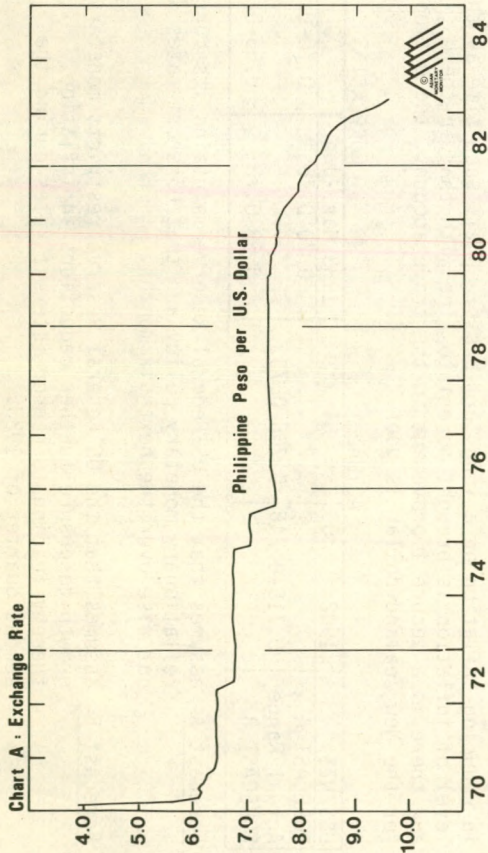
It is clear from Chart E that the present rate of growth in the money supply is the lowest for several years and, if sustained, it would undoubtedly limit longer term weakness in the New Zealand dollar. Nevertheless the costs of reducing inflation will soon become apparent. New Zealand faces the prospect of a recession during 1983 at a time when other economies are likely to be recovering. This is likely to severely test the authorities resolve in reducing inflation on a long term basis. Until such time as the level of inflation is brought more into line with that in the US, and there is a secure improvement in the trade account, the outlook for the New Zealand dollar is poor.

US\$/NZ\$	ACTUAL			FORECAST	
	1982	Q3	Q4	1983 Mar.-Jun.	Q3
FORECAST A				0.70-0.75	0.70-0.75
Actual Range	0.718-0.746		0.706-0.733		
FORECAST B				0.68-0.73	0.65-0.70

Forecast A assumes that the US Federal Reserve maintains its current inflationary monetary policy and that US short rates do not rise over the next six months.

Forecast B assumes that the US Federal Reserve restricts monetary growth to ensure further reductions in inflation, thereby leading to higher interest rates during the second quarter of 1983.





Having declined at a fairly constant rate against the US dollar over the first half of 1982, the rate of depreciation of the peso has accelerated quite markedly over recent months. This reflects a continued deterioration in the Philippine economy as the prices of the Philippines' major agricultural commodity exports have remained weak, as well as a fundamental lack of competitiveness as the inflation rate has not fallen in line with that of the rest of the world.

During 1982 the overall balance of payments deteriorated to eventually show a record deficit of US\$1.14 bn for the year. This is explained by a growth in the trade deficit to US\$2.8 bn from US\$2.2 bn in 1981, arising from a 13% decline in exports compared to the 1.8% decline in imports. Despite this growth in the balance of payments deficit, monetary growth as measured by M2 has picked up rapidly, reaching a year-on-year rate of 21.3% by October. Consequently consumer price inflation although it has fallen to 8.5% is still high when compared to the extent of the falls in commodity prices.

The reason monetary growth has accelerated in spite of the deterioration in the balance of payments position is that the budget deficit has been monetised. The weakness of commodity prices and the

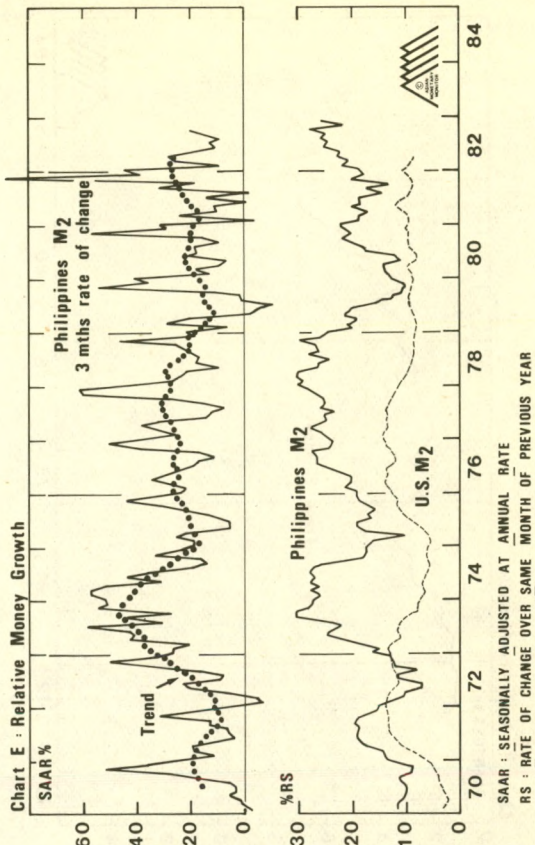
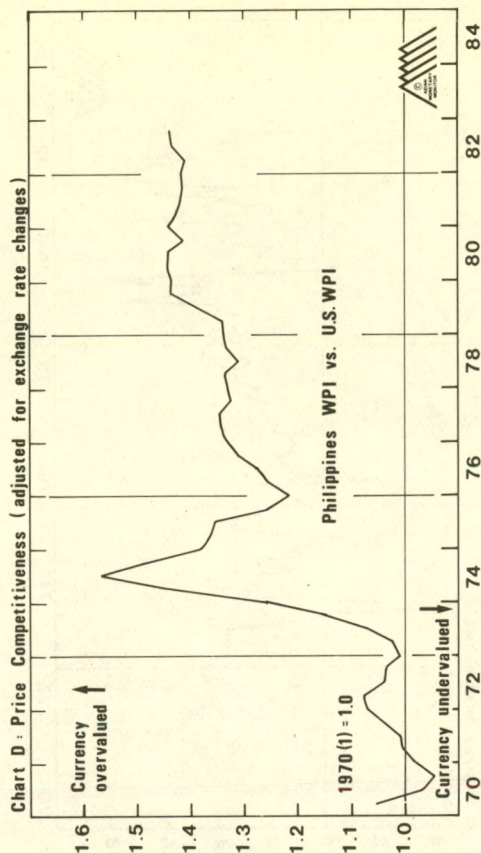
economy has meant that the government's budget deficit grew well in excess of the target 3% of GNP in 1982, as revenues fell short of expectations, the final deficit reaching ₱14.4 bn, or 4.6% of GNP. In financing the budget deficit the authorities' hands have been tied by the need to keep within the US\$2.4 bn target for the increase in foreign borrowing (imposed to keep the foreign debt service ratio under the legal limit of 20%), and by the desire to avoid 'crowding-out' private borrowers from domestic financial markets. The result of this has been that close to half of the deficit has been monetised by direct borrowing from the central bank. By October 1982 the central bank's net claims on (i.e. net lending to) government were ₱6.47 bn higher than year earlier levels, an increase which almost entirely offset the increase in the central banks' net foreign liabilities arising from the balance of payments deficit. Consequently, the monetary base has continued to grow despite the drain on foreign reserves resulting from the adverse balance of payments position.

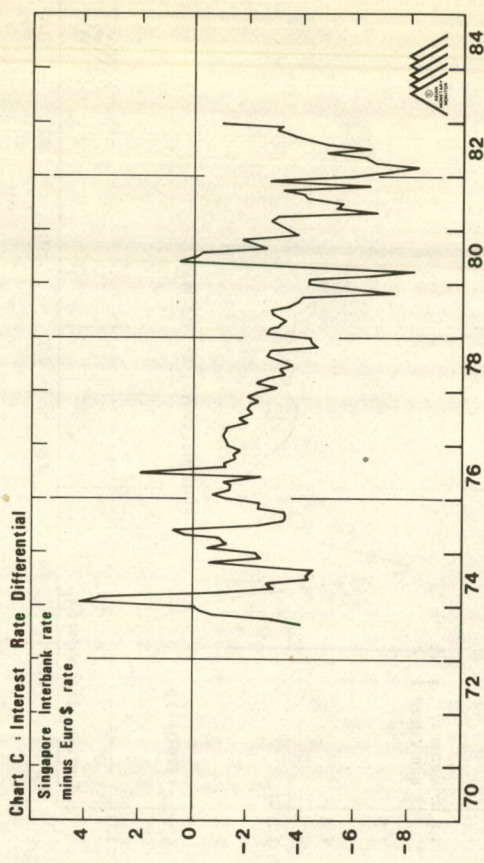
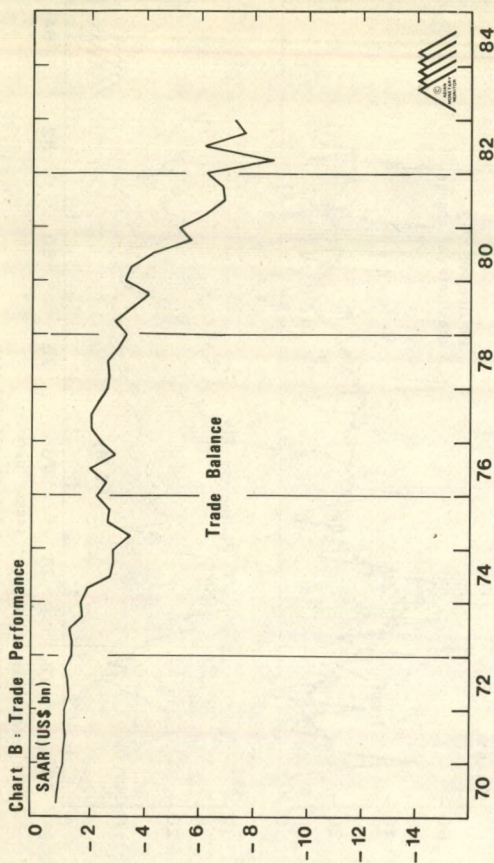
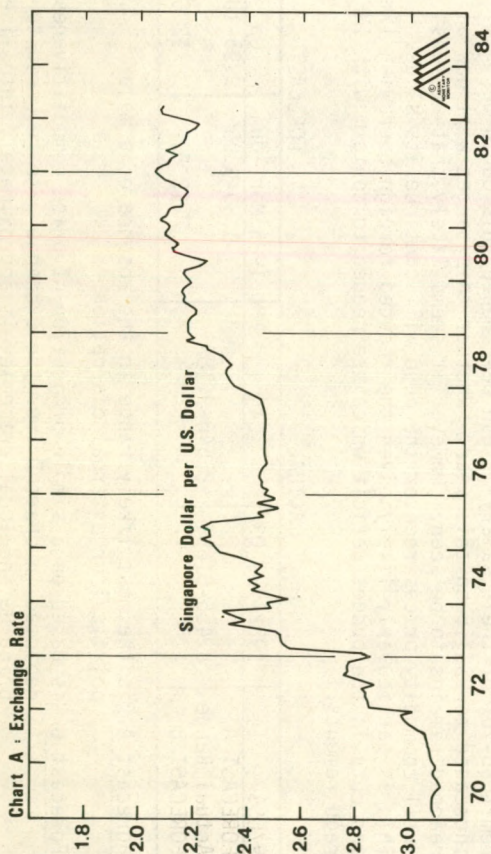
The outlook for the shorter term remains somewhat gloomy as Philippine commodities are likely to lag in the upswing of the world economic cycle. The trade account will benefit from falls in the oil price, but this may be offset by reduced receipts from Filipino contract workers in the Middle East. Remittances from overseas workers contributed US\$700-US\$800 million to foreign exchange earnings last year, and with new legislation requiring overseas workers to remit 50-70% of their salary it had been hoped this could be increased to US\$1.5 bn this year. Whether this target will now be reached remains to be seen. However it seems likely that at least until commodity prices recover the peso will continue its slide. This is particularly likely given the reduced foreign borrowing limit and cuts in the budget deficit which are needed to conform with IMF requirements.

₱/US\$	ACTUAL			FORECAST	
	1982	Q3	Q4	1983 Mar.-Jun.	Q3
FORECAST A				9.50-9.95	9.95-10.15
Actual Range	8.455-8.689		8.646-9.182		
FORECAST B				12.5	12.6

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a simple projection of price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels approximately into line.





In our last exchange rate forecast for the Singapore dollar (AMM Vol. 6 No. 2) we pointed to higher monetary growth and the expected strength of the domestic economy, with an accompanying deterioration in the trade account, as factors which might tend to depress the Singapore currency in the medium term. The actual outcome has been that, although liquidity has indeed been very easy and the domestic economy relatively strong, the Singapore dollar is currently back close to the record high levels (\$S2.04) reached against the US dollar at the very end of 1981. Although at first sight contradictory, these phenomena can be explained by the failure of the overall balance of payments to deteriorate despite a growing deficit on the trade account. This is a result of increases in net receipts earned by the financial sector and a sustained high level of capital inflows into the Singapore economy.

The Monetary Authority of Singapore (MAS) conducts its monetary policy through management of the exchange rate, and therefore trends in both monetary growth and the exchange rate can be explained largely by movements in the overall balance of payments. Throughout most of the 1970's the MAS allowed the exchange rate to appreciate in the wake of balance of payments surpluses and in this way kept

monetary growth under control. However, since the final quarter of 1981 the MAS has shown itself unwilling to continue with this policy. After increasing by 10% in 1981, industrial production declined by 6% last year. The sharpness of this downturn has meant that the MAS has been unwilling to allow the competitiveness of the manufacturing sector to suffer further at a time when total world trade has been declining.

The problem has been that due largely to sustained high capital inflows (possibly due to the problems in Hong Kong and Indonesia) Singapore's overall balance of payments surplus for 1982, at US\$1.21 bn, represents the highest on record. The necessary consequence of a large balance of payments surplus and an unwillingness to allow the currency to appreciate has been a rapid pick-up in monetary growth. Since April 1982 monetary growth has been increasing sharply, reaching a year-on-year rate of 19.7% (as measured by M2) in November. At a time when consumer price inflation has now fallen below zero (-0.4% year-on-year in January) this represents an extremely high rate of real monetary growth.

As long as capital inflows remain at such high levels there is no reason to expect the Singapore dollar to weaken against the US dollar. In addition, since Singapore's exports may be expected to improve sharply with any pick-up in the world economy, the trade balance will strengthen. Nevertheless, in the medium term there is the risk of weakness as a result of a decline in capital inflows, while the scope for appreciation is limited by the MAS's desire to keep the exchange rate down.

S\$/US\$	ACTUAL		FORECAST	
	1982 Q3	Q4	1983 Mar.-Jun.	Q3
FORECAST A				
Actual Range	2.118-2.175	2.1145-2.228	2.02-2.10	2.02-2.10
FORECAST B				
			2.08-2.16	2.14-2.22

Forecast A assumes that the US Federal Reserve maintains its current inflationary monetary policy and that US short rates do not rise over the next six months.

Forecast B assumes that the US Federal Reserve restricts monetary growth to ensure further reductions in inflation, thereby leading to higher interest rates during the second quarter of 1983.

Chart D : Price Competitiveness (adjusted for exchange rate changes)

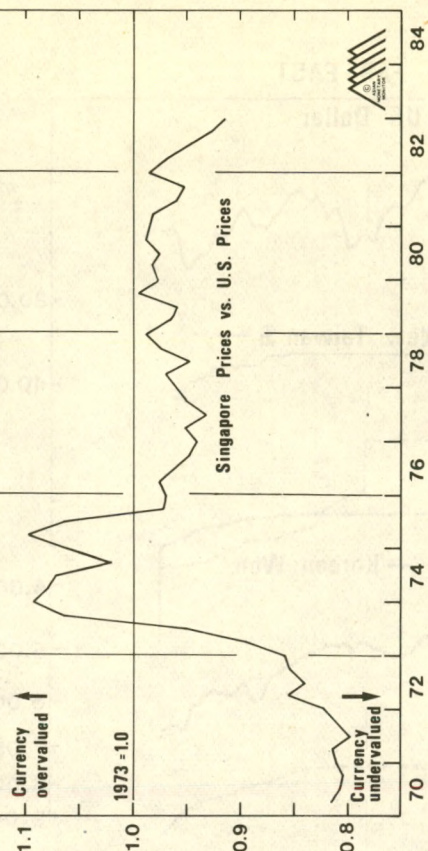
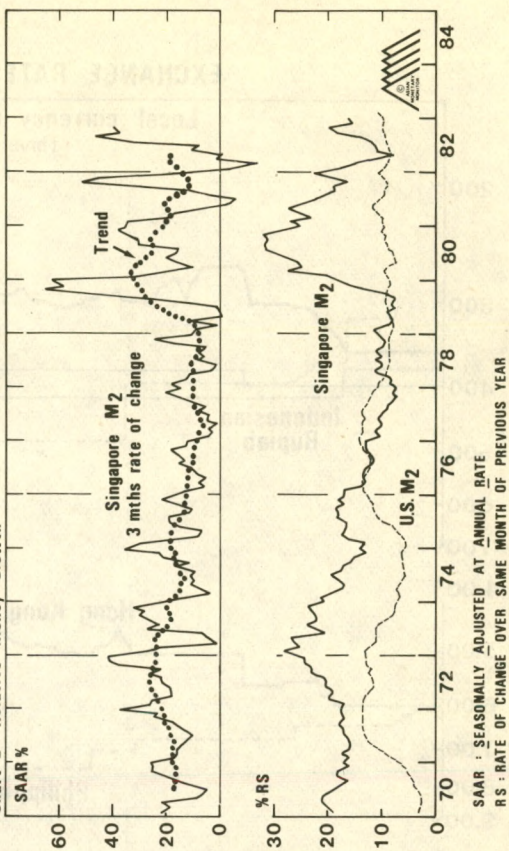


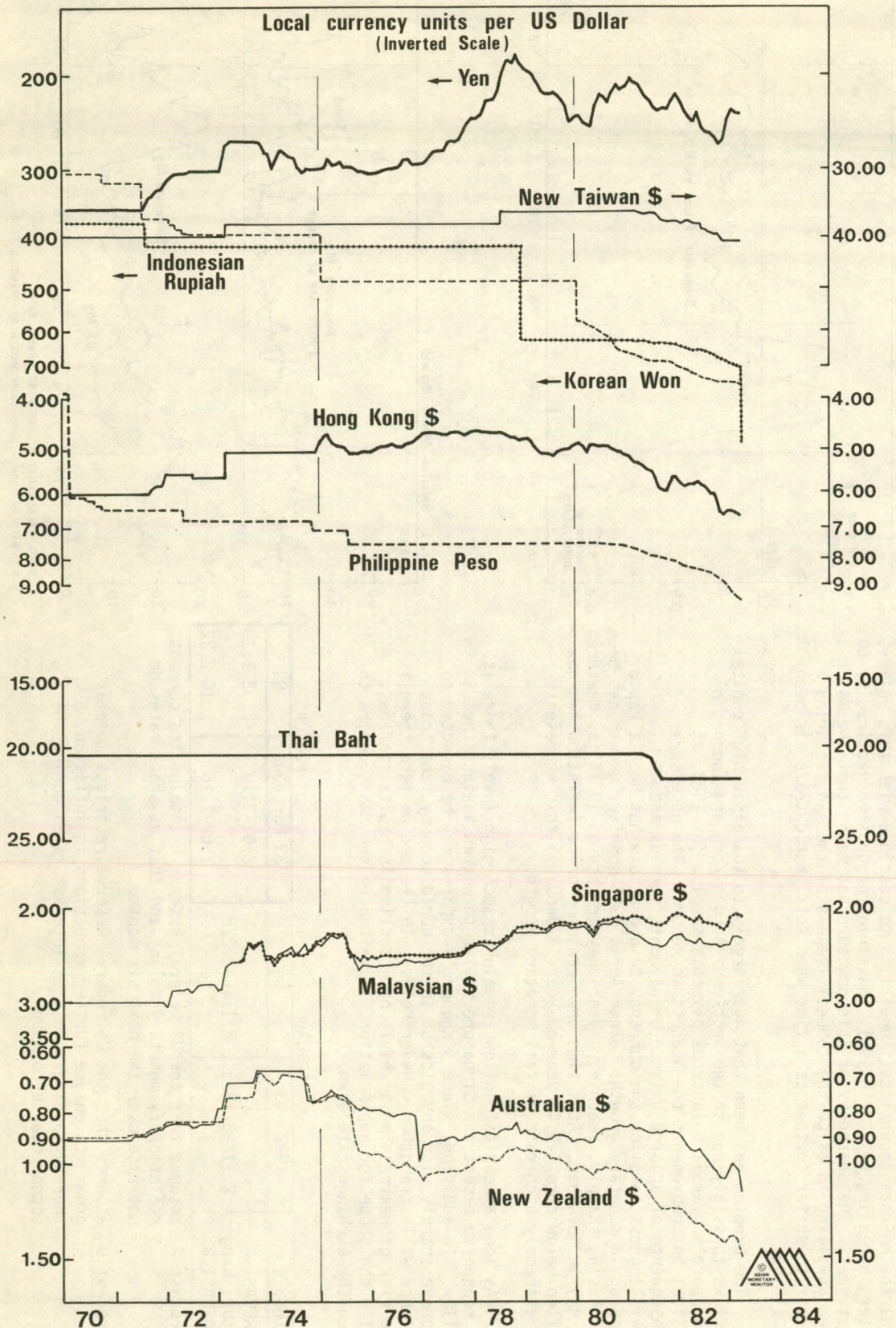
Chart E : Relative Money Growth



SAAR : SEASONALLY ADJUSTED AT ANNUAL RATE

RS : RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

EXCHANGE RATES IN THE FAR EAST

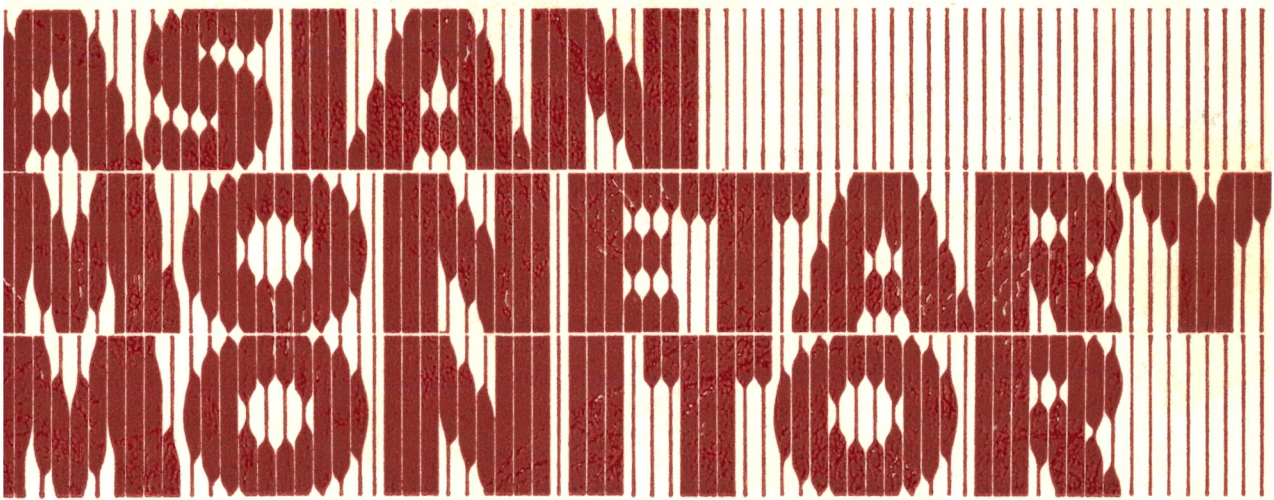




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

INDONESIA

THE FUNDAMENTAL FACTORS WHICH LED TO DEVALUATION

On March 30 the Indonesian Rupiah was devalued by 27.6% against the US dollar, from a rate of Rps 702.5 to a new rate of Rps 970. Pressures towards devaluation had been building since early 1982 as the current account deficit began to deteriorate rapidly and foreign reserves began to dwindle in the wake of the continuing poor performance of non-oil exports and the weakening world oil market.

Serious problems had emerged in April last year when OPEC cut Indonesia's oil production ceiling from 1.6m to 1.3m barrels per day. In fact, as world oil demand continued to fall production began to drop below the ceiling such that by November a 47 cent per barrel downward adjustment in the international price was necessary to boost demand for Indonesian oil. Yet despite the magnitude of the fall in Indonesian oil production and export in 1982 (crude petroleum production for the whole year was down by 16% from 1981, making it the lowest level of production since 1975), devaluation was resisted by the authorities and the exchange rate supported by a high level of overseas borrowings. However, a tighter budget for 1983-84 in response to IMF advice, and a climbing debt service ratio limited the possibilities for further heavy increases in foreign borrowing. The devaluation finally became inevitable after the OPEC reduction in its marker price. The US\$5 drop in Indonesia's oil price represented a loss of at least US\$2 bn from the current account of the balance of payments.

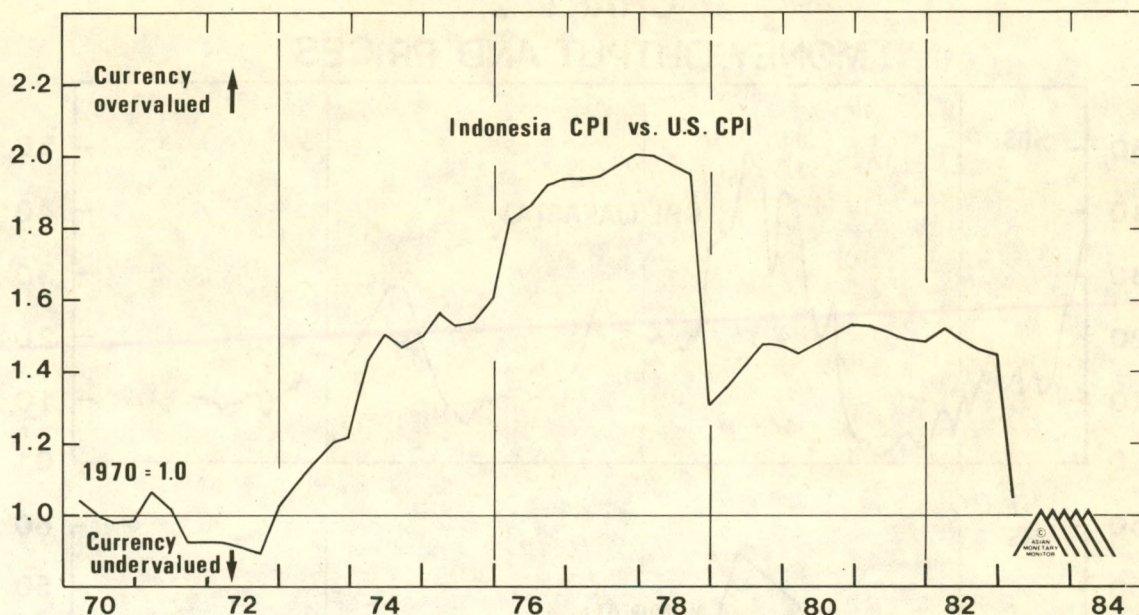
Although it was the deterioration in the world oil market which eventually sealed the fate of the Rupiah, the forces leading to ultimate devaluation were set in motion in 1978/79 with the late 1978 devaluation and oil price hikes of 1979/80 (see AMM Vol. 4 No. 1). This can be seen from an examination of Charts 1 and 2.

Chart 1 illustrates the degree of overvaluation of the Rupiah when estimated on a purchasing power parity basis i.e. it shows the degree of overvaluation of the Rupiah relative to the rate that would be required to compensate for the higher inflation rate in Indonesia than in the US since the base date of 1970. The chart shows that prior to the devaluation the Rupiah was approximately 40% overvalued relative to the US dollar using a base date of 1970.

The Rupiah became progressively more overvalued from 1973 as Indonesia's inflation rate remained high relative to the levels prevailing in the rest of the world. As with other countries of the region, the commodity boom of 1972/73 had led to an increase in foreign assets and a sharp acceleration of monetary growth and inflation (Chart 2). However, following this, Indonesia did not suffer as severe a slowdown as its South East Asian neighbours in 1974/75, and hence inflation did not fall back as rapidly.

INDONESIA : CHART 1

INTERNATIONAL PRICE COMPETITIVENESS



The main reason for this can be found in the increased importance of oil to the Indonesian economy. A massive jump in the value of oil exports in 1974, brought about by the price hike of that year which took crude petroleum and products to 70% of total export earnings (from 50% in 1973), led to sustained balance of payments surpluses and hence (with the fixed exchange rate) prevented monetary growth from falling rapidly. In 1976 and 1977 the balance of payments surplus was further exacerbated by a large rise in crude petroleum production, which rose by 29% over the two year period. The net effect was that the economy failed to adjust completely after the 1973 boom and was able to support an increasingly overvalued currency only by an increasing dependence on oil.

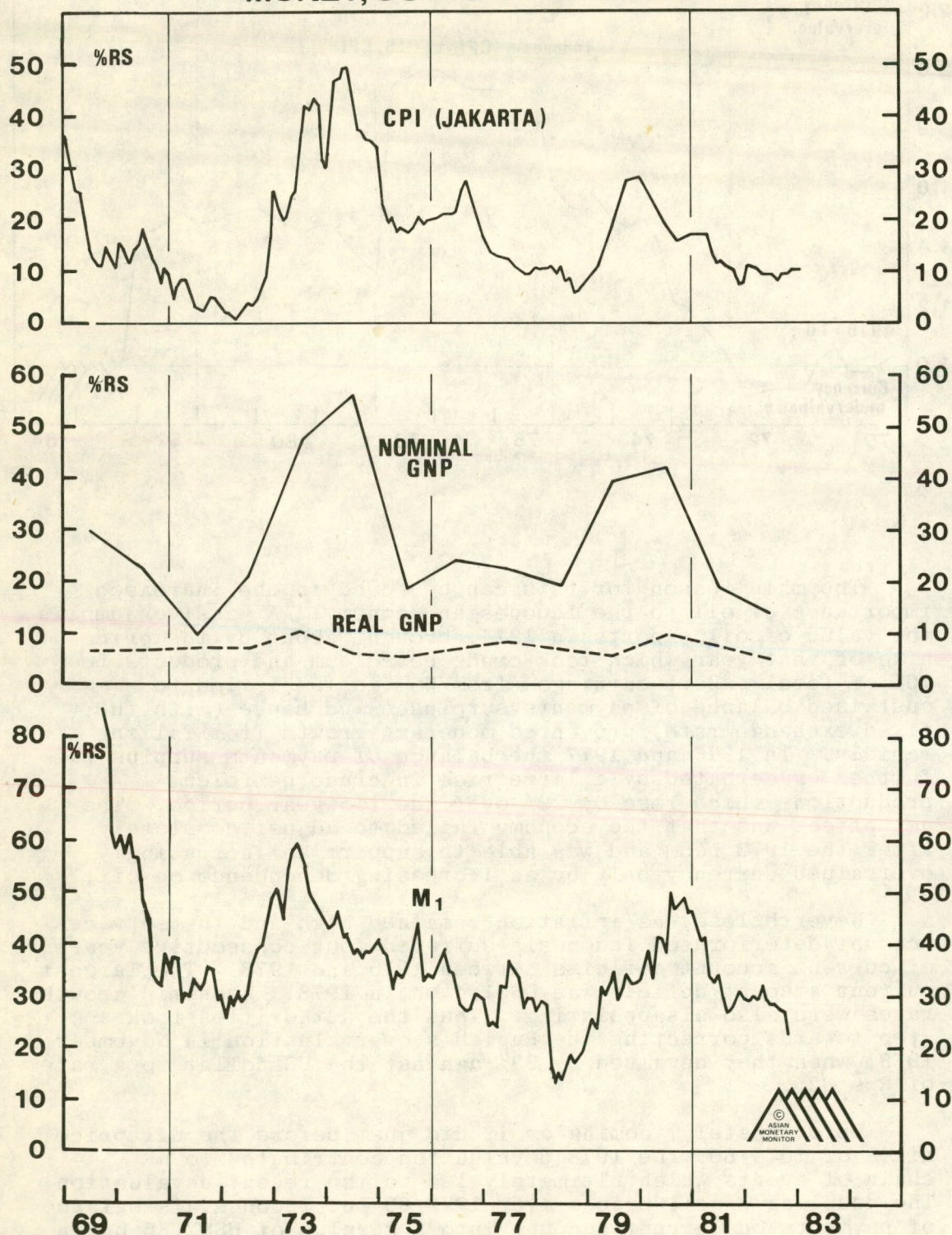
Nevertheless, as inflation remained high and the services account deteriorated Indonesia suffered four consecutive years of current account deficits between 1975 and 1978. The largest current account deficit was US\$1.4 bn in 1978. Economic growth rates were also disappointing. Thus the authorities took a step towards correcting the Rupiah's overvaluation in November 1978, when they devalued by 33% against the US dollar to a rate of Rps 625.

Unfortunately, coming as it did just before the oil price hikes of 1979/80, the 1978 devaluation contributed to a chain of events which ultimately led to the recent devaluation. The doubling of oil prices over 1979/80 put Indonesia's balance of payments on current account into a surplus of US\$2.85 bn in 1980 which, on top of the devaluation, led to a very large

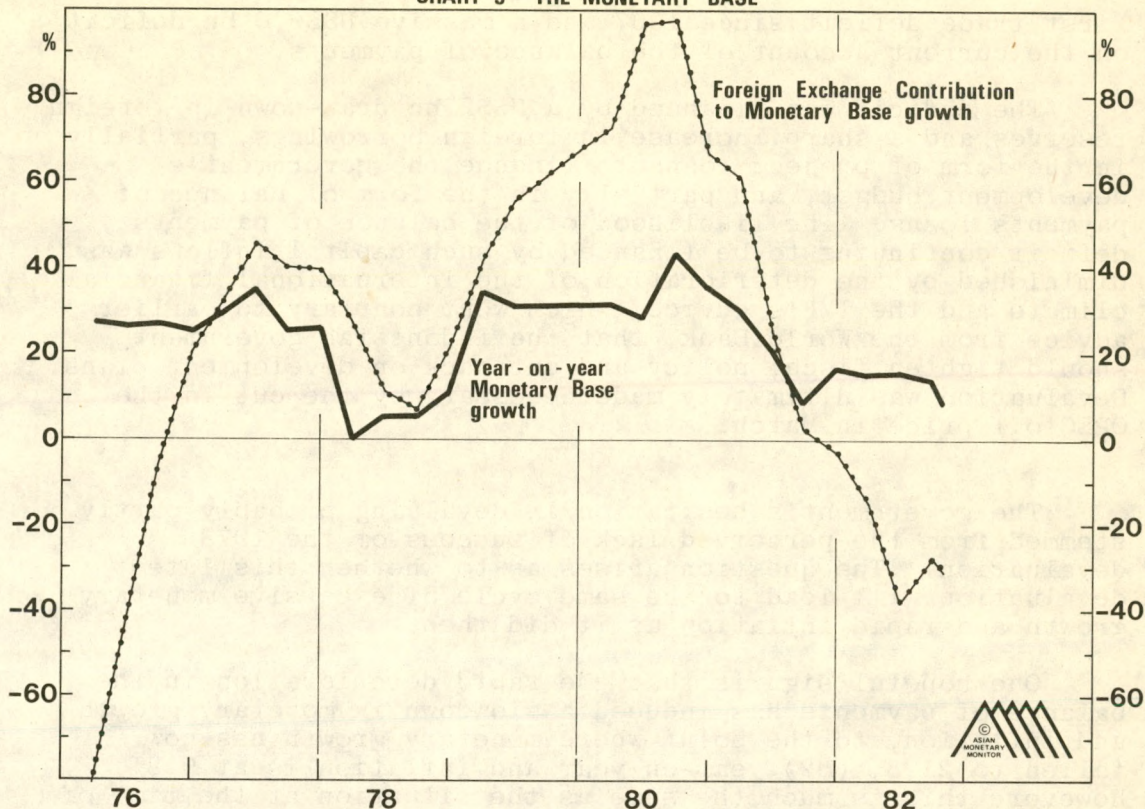
INDONESIA

CHART 2

MONEY, OUTPUT AND PRICES



INDONESIA
CHART 3 : THE MONETARY BASE



increase in the rupiah value of Bank Indonesia's net foreign assets. As revenues from oil tax form 60%-70% of government revenue the rise in oil prices inflated government revenues, and the build-up in net foreign assets was prevented from translating into an increase in the monetary base of the same magnitude by a build-up in government deposits at the Central Bank. This is illustrated on Chart 3, which shows, nevertheless, that the monetary base still did expand to the point where it was growing at a year-on-year rate of 44% in mid-1980. This was accompanied by a pick up in monetary growth, as measured by M2, to a rate of 56% year-on-year. Consequently inflation remained high and Indonesia began to lose much of the competitive advantage gained from the 1978 devaluation.

With the high rate of monetary growth and an overheated economy in 1980, imports soared. Import growth was 50% in 1980, while non-oil export growth began to slow after the peak reached in 1979. In 1981, as commodity prices turned down non-oil exports fell by a sharp 18.6%, while imports, fuelled by the continuing high rate of monetary growth and overvalued exchange rate, grew by 22.5%. Thus the current account turned back to deficit and the Rupiah was allowed to slide downwards in a managed float from the beginning of 1981.

The balance of payments position grew much worse in 1982. While imports continued to grow at a relatively high 9%, non-oil exports fell by a further 10%. Coming on top of the 19% fall in petroleum exports this left Indonesia with its

first trade deficit since 1967 and a massive US\$6.6 bn deficit on the current account of the balance of payments.

The deficit was financed by a US\$2 bn draw-down in foreign reserves and a sharp increase in foreign borrowings, partially in the form of project loans to finance the government's development budget, and partially in the form of balance of payments loans. The likelihood of the balance of payments deficit continuing to be financed by such capital inflows was diminished by the deterioration of the international financial climate and the IMF's advice, which went contrary to earlier advice from the World Bank, that the Indonesian government should tighten fiscal policy and cut back on development plans. Devaluation was ultimately made necessary by the cut in the OPEC oil price in March.

The government's hesitation in devaluing probably partly stemmed from the perceived lack of success of the 1978 devaluation. The question arises as to whether this latest devaluation will lead to the same cycle of excessive monetary growth and rapid inflation as it did then.

One hopeful sign is that the rapid deterioration in the balance of payments has induced a slowdown in monetary growth and inflation, to the point where monetary growth has now fallen to 21.3% (M2) year-on-year and inflation is at 9.8%. However, this is much the same as the situation at the time of the 1978 devaluation, after which within a year inflation had risen to nearly 30%.

Nevertheless, there are two main differences between the situation at the time of the 1978 devaluation and the situation now.

The first is that, as Chart 1 illustrates, the devaluation has restored the Rupiah to a much more competitive level than was the case with the 1978 devaluation. In fact, even if the purchasing power parity estimate is calculated as an average of the parity rates suggested by the base years of 1971 and 1973 (instead of 1970), also years in which the current account was in relatively small deficit, then the recent devaluation can be seen as restoring the Rupiah almost exactly to its purchasing power parity level. A more competitive exchange rate should help to restrain import growth over a longer period of time.

Secondly, and most importantly, it is unlikely that we are now at the beginning of an oil and commodity boom of the type experienced in 1979/80. The present state of the world oil market suggests that the next rise in oil prices is probably at least two years away. Similarly, as the world's major Central Banks are unlikely to let monetary growth get out of hand to the same extent this time round, the peak in commodity prices in general is probably some long way off and we are unlikely to see a rapid, speculative, run up in commodity prices.

FORECAST: This suggests that major inflationary forces will not reassert themselves in the immediate future. Nevertheless, we are at the beginning of a world business recovery and hence close to the beginning of a cyclical improvement in Indonesia's balance of payments. With a recovery in export demand and with the devaluation, the rupiah value of Indonesia's export earnings and government revenues will rise. The major risk, as far as the currency is concerned, is that the authorities will allow higher government rupiah revenues to translate into higher spending and make no attempt to counteract the effect of an improved balance of payments position upon monetary growth. If this occurs then we may expect another cycle of rising monetary growth, rising inflation and ultimately, in three or four years' time, further devaluation.

JAPAN

THE SECULAR SLOWDOWN IN ECONOMIC GROWTH

Since the immediate postwar hyperinflation and the imposition of the economic stabilisation programme known as the Dodge Line in 1949 the Japanese economy appears to have experienced three distinct growth phases. The first phase, the Era of Rapid Growth, from 1950 to 1970 or thereabouts saw the Japanese economy growing at 10.0% p.a. in real terms. Since 1970 there has been a distinct slowdown in the growth rate, with growth averaging 4.9% p.a. over the period 1970-80, and a more recent slower phase since 1980 during which growth has averaged just 3.2% p.a. For the year 1983 the government is forecasting growth of 3.4%, and for the period 1983-87 the Economic Council has forecast a growth rate in the range 3-4% p.a. It is widely agreed that a return to double digit real growth is inconceivable today. The consensus view, therefore, is that the Rapid Growth Era is over and that for the foreseeable future Japanese growth will be an unexciting 3-4%, somewhere near the norm for the USA and major European economies in most of the postwar years.

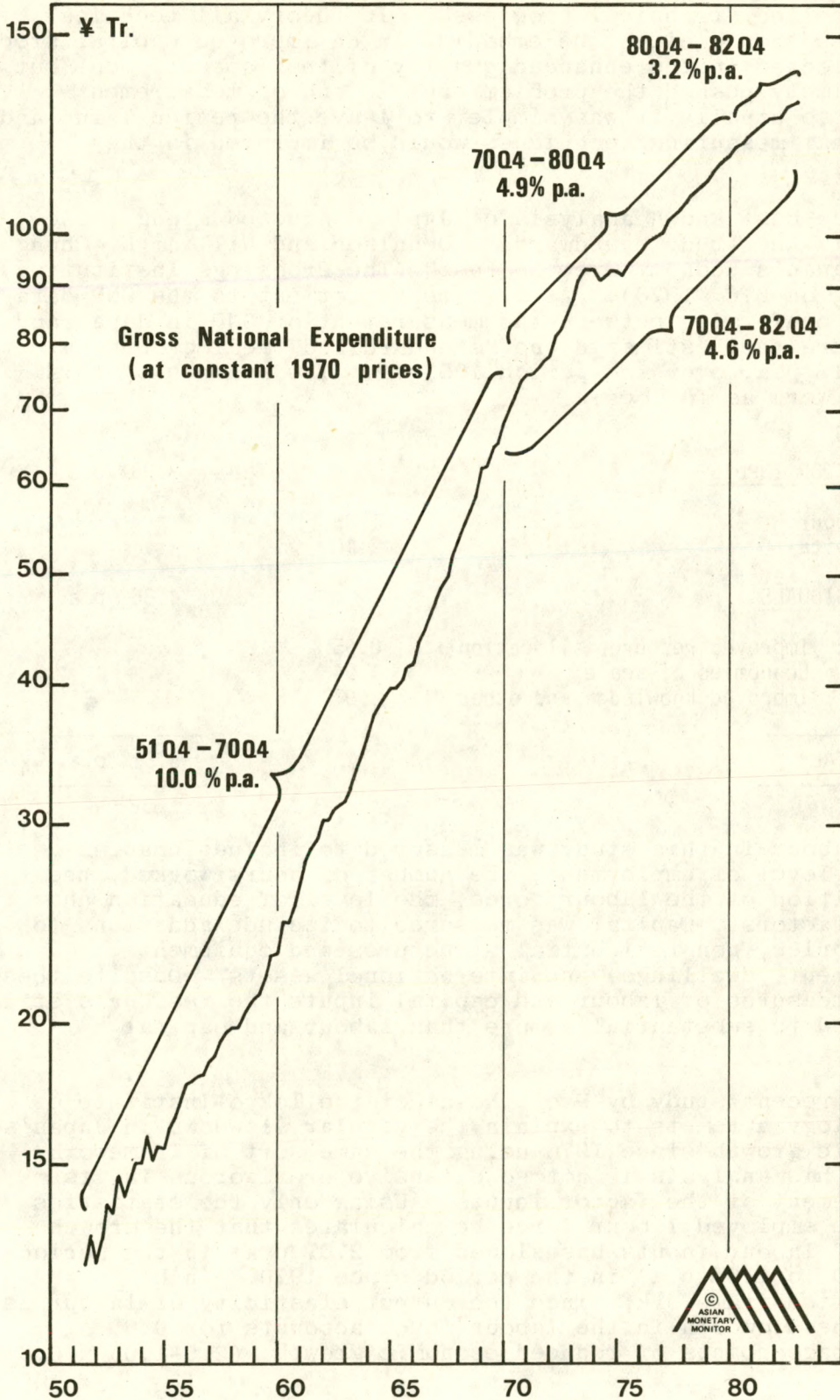
Yet the slowdown in Japan's economic growth has occurred precisely at a time when, by some measures, the savings rate has actually risen. Since higher savings must translate into greater capital investment which in turn raises productivity, surely one should expect higher growth, not lower growth. How can this apparent paradox be explained?

Before answering this question it is necessary to define a framework from which an answer can be generated. The conventional components-of-GNP analysis - i.e. consumption spending plus investment spending plus exports minus imports - is plainly not appropriate to this question because it only tells us the composition of final spending or the composition of the output rather than the source of the input. If we look at the shares of national income i.e. the division of income into wages, interest, rent and profits this will tell us the components of total income, but these incomes are in turn derived from certain factors of production. In classical economic analysis the factors of production corresponding to these four forms of income were labour, capital, land and entrepreneurship. Accordingly, to identify the sources of growth it would be necessary to measure the growth of each of these four items over a period of time. Conceptually this presents severe measuring problems, but assuming that this problem could be solved, this would be a viable approach.

Modern neoclassical analysis is more cavalier. Labour and entrepreneurship are lumped together as simply different classes of labour, and land is reckoned to be one of the capital inputs, so this reduces the identifiable sources of economic growth to just two - labour and capital. However, when economists began to do practical, empirical work on these questions they always found that, no matter how much they tried

JAPAN

Chart 1 : Real Economic Growth



to adjust for the different quality of labour inputs and the improvements in capital equipment, there was still a significant portion of growth that could not be explained. This residual was labelled "technical progress". In theory all technical progress should either be embodied in an improved capital stock, or reflected in the enhanced quality of the labour force, but that simply pushed the problem back to one of measurement again, so usually it was simpler to leave the residual in, and hope that measuring techniques would be improved in the future.

The best known analysis of Japan conducted along these lines is the study by Edward F. Dennison and William K. Chung "How Japan's Economy Grew So Fast" (The Brookings Institution, Washington D.C. 1976). After some adjustment to the GNP data to ensure conformity between the measurement of GNP in Japan and elsewhere they estimated the "standardized" real growth rate to be 8.81% p.a. over the period 1953-71. The sources of this growth were as follows:

<u>FACTOR INPUTS</u>		3.95% p.a.
Labour	1.85	
Capital	2.10	
<u>RESIDUALS</u>		4.86% p.a.
inc. Improved resource allocation	0.95	
Economies of scale	1.94	
Improved knowledge and other	1.97	
<u>TOTAL</u>		<u>8.81% p.a.</u>

Labour in this study was measured to include changes in the level of employment, the number of hours worked, the composition of the labour force, the level of education and other factors. Capital was measured to include additions to inventories, non-residential structures and equipment investment, dwellings, and international assets. Despite these broad measures of labour and capital inputs the residuals still amounted to substantially more than labour and capital together.

A recent study by Prof. Kosai of the Tokyo Institute of Technology attempts to explain the secular slowdown in Japan's economic growth since 1970 using the same sort of framework, though his analysis is not so extensive or rigorous in its measurement of the factor inputs. Using only the statistics for the employed labour force he calculates that the growth rate of labour inputs has slowed from 2.0% p.a. in the period 1955-70 to 1.0% p.a. in the period since 1970. In his simplified framework, since the output elasticity of labour is 0.6, the slowdown in the labour force accounts for 0.6 percentage points of reduced economic growth: $(2.0-1.0) \times 0.6 = 0.6$.

On the capital side Prof. Kosai again takes a short cut by using only the growth of the gross fixed business capital stock as his measure of capital inputs. Since this item slowed from 12.4% p.a. in the period 1960-70 to 6.3% in 1975-80 (all figures in real terms) - which he attributes to the two oil shocks, a worsening of the terms of trade and reduced corporate profits - he estimates that this lower rate of capital formation explains 2.5 percentage points of Japan's reduced growth rate:

$$(12.4-6.3) \times 0.4 = 2.5 \quad (0.4 \text{ is the output elasticity of capital})$$

These two rough and ready calculations account for a slowdown amounting to 3.1% p.a. In round numbers, if the growth rate slowed from 10% in the 1960s to 5% in the 1970s, 3% of the slowdown is due to reduced factor inputs - reduced growth of the labour force and less investment by corporate businesses. Prof. Kosai attributes the other 2% of the slowdown to a slower rate of technical progress and other factors (see below), though this is simply an assertion. But the other 2% could be partly due to factors which he has omitted from his measurement of labour and capital but which Dennison and Chung's more comprehensive measures managed to capture, as well as to those infamous residuals. Clearly this explanation is not entirely satisfactory, but it does seem to accord roughly with experience in that the population and the labour force have grown more slowly in recent years and that there was a prolonged hiatus in corporate investment in Japan (from 1974 to 1978) following the first oil crisis. However, one must be careful not to allow purely cyclical variations in the growth rate of the components of GNP to obtrude into the analysis of this secular problem.

Prof. Kosai suggests that aside from slower technical progress, there are two additional factors accounting for the slowdown in Japanese economic growth. The first is the fact that, unlike the period of the 1950s and 1960s, the 1970s saw little reallocation of labour from the agricultural sector to the manufacturing sector, so that the increases in average productivity which had resulted from this kind of reallocation of the labour force were no longer available in the 1970s. Similarly the increase in the proportion of the labour force employed in the service sector (where technical progress or productivity gains are less easy) meant that there were fewer gains in overall productivity from the reallocation of labour than there would have been in an economy whose manufacturing sector was growing faster than either agriculture or services. However, although improvements or lack of improvements from resource allocation are identified separately by Dennison and Chung and also by Prof. Kosai they are really part of the contribution to growth from labour inputs (when properly measured).

The second factor accounting for the slowdown, in Prof. Kosai's view, is the direct and indirect impact of higher energy costs. Indirect costs include, for example, the deterioration in the terms of trade as more resources have to

be channelled into exports to pay for higher cost energy imports. In a sense this proposition is analogous to the previous one. When energy prices were sharply increased in the 1970s the revised patterns of demand and comparative advantage which emerged were quite unfavourable to large sectors of the Japanese economy. The rise in energy prices had in effect rendered significant parts of the Japanese capital stock obsolescent overnight; the change in price structure and the change in demand required an urgent reallocation of capital to more productive uses. The practical effect was that large parts of the capital stock - petrochemical refineries, aluminium smelters etc. - had to be written off far more rapidly than had originally been anticipated and it has taken time for the devalued capital stock to build up again. The oil crises are significant for the analysis of Japan's secular growth rate in the sense that - if the change in energy prices is permanent - they point to a misallocation of capital (and labour) which has to be rectified if the economy is to return to its optimum growth path.

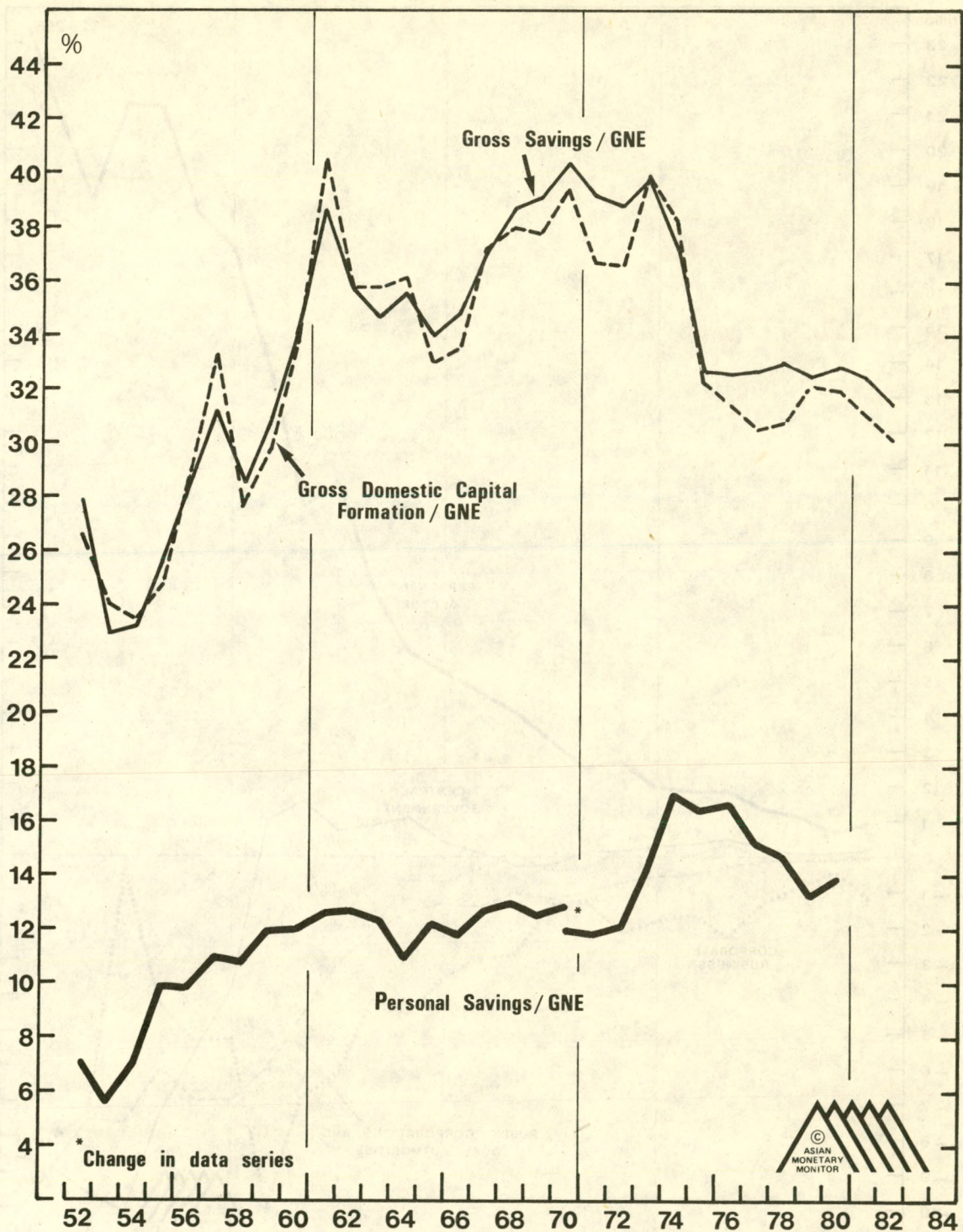
Even so, despite higher savings and an improved allocation of resources after adjustment to the two oil shocks it is unlikely that the Japanese economy will return to a sustained growth rate of 5% p.a. or more. The reason is that although savings are higher in both absolute terms and as a proportion of GNP (see Chart 2), they are being entirely absorbed by activities which contribute less to the growth rate than the additions to labour and capital did in the 1950s and 1960s.

In retrospect, as Chart 2 suggests, the sudden rise in the savings rates in the early 1970s appears to have been a temporary phenomenon, and rates are gradually now returning to the more normal levels of the late 1960s. The upsurge in savings rates in the corporate sector (reflected in the gross savings rates) was largely a cyclical phenomenon resulting from the high level of corporate profits in the boom years 1966-69, and the 1972-73 boom. In the personal sector the steep rise did not occur until 1974-75. The early part of the rise in the late 1960s and early 1970s can be interpreted as a gradual transfer or percolation of profits from the companies to the household sector, while the second, steeper, part of the rise can be viewed as a response to the general economic uncertainty precipitated by the first oil crisis. To an extent, therefore, it is coincidental that the Japanese economic growth rate appears to have slowed down just as the savings and investment rates reached abnormally high levels. It could of course be argued that the return on the new investments made in the early 1970s (in tanker fleets, petrochemical facilities etc.) would have been low and this itself would have reduced the ultimate economic growth rate, but it would be almost impossible to separate out such possible effects from the actual consequences of the first big oil price hike.

However it is possible to explain the coexistence of a high rate of savings and a relatively low rate of economic growth by considering the way those savings are being absorbed. By comparison with the 1950s and 1960s a far greater proportion

JAPAN : CHART 2

SAVINGS AND INVESTMENT RATIOS

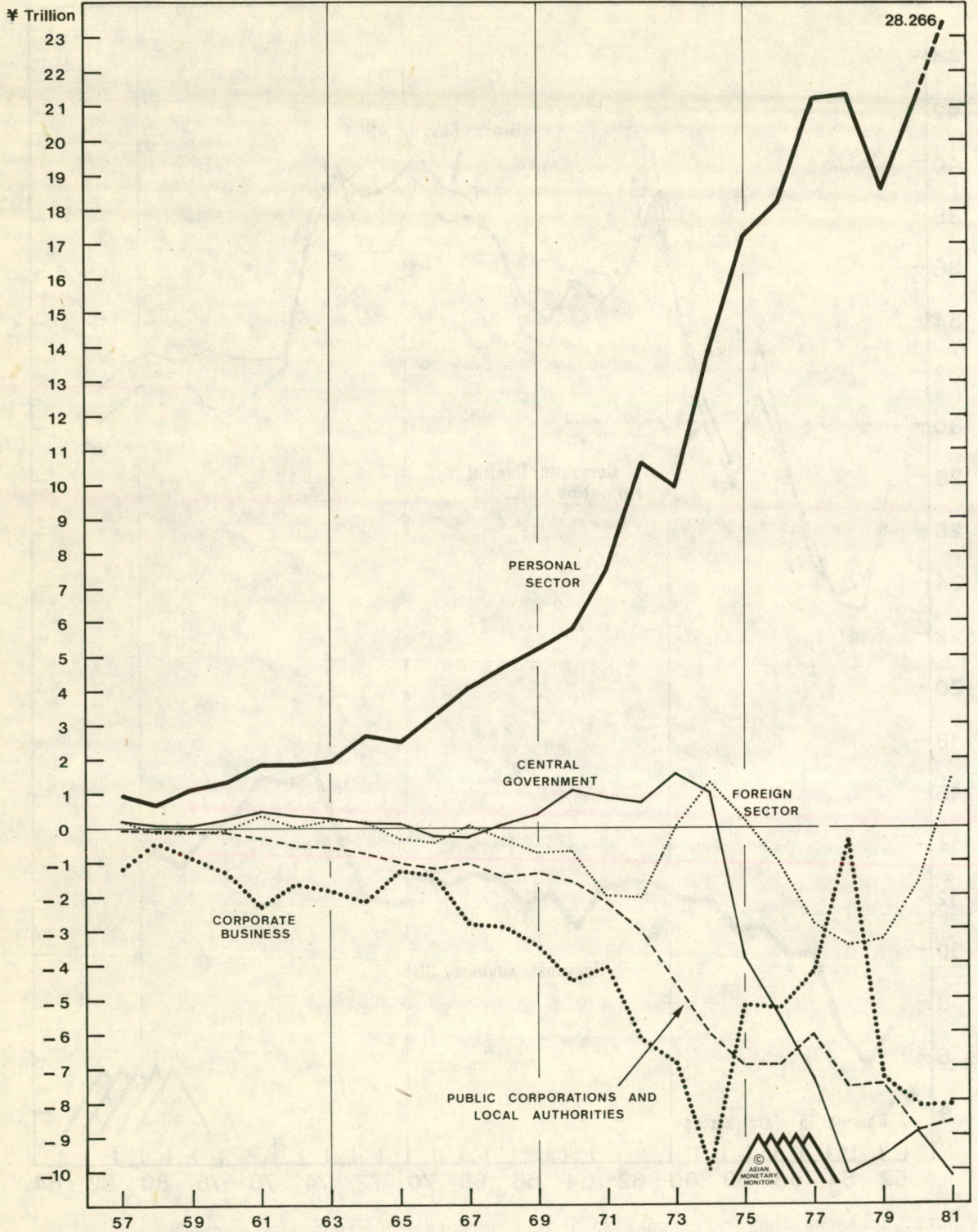


Note: Gross savings = Personal savings + corporate savings + government surpluses + capital consumption allowances.

Gross domestic capital formation = Gross domestic fixed capital formation + increase in inventories.

JAPAN

CHART 3: FLOW OF FUNDS BY SECTORS (Annual data)



of Japanese savings goes to replacement of the existing capital stock, simply because the annual depreciation on the larger capital stock is so much greater. This results in lower growth of the amount of capital which in turn is reflected in a lower economic growth rate. Next, not only has government expenditure grown as a proportion of GNP in recent years thus reducing the area of the economy which is subject to the commercial discipline of profit and loss, but the government budget deficit now absorbs a substantial proportion of personal savings. In the pre-1974 period the government used to operate with consistent budget surpluses which contributed to the net savings available to the personal and corporate sectors for new residential or plant and equipment investment.

The third major diversion of savings away from improving or increasing Japan's capital inputs is the flow of Japanese investment into financial assets overseas. In part this is a cyclical phenomenon encouraged by the wide real interest rate differential between Japan and other countries, particularly the USA, but in part it is a long term phenomenon too. One of the classic signs of a maturing economy is that as the domestic rates of return on capital appear to slip, capital is exported to earn higher rates of return overseas. With real interest rates unusually high overseas that incentive is exceptionally strong at present, but even when those high real rates abroad come down somewhat the outflow of Japanese capital is likely to continue. This is because with Japan's underlying inflation rate being so low and savings being so high it is probable that the supply of capital from Japan will remain very cheap. On the balance of payments a persistent capital outflow must be matched, under a regime of floating exchange rates, by a current account surplus. In the longer term, therefore, critics of Japan's current account surpluses cannot also expect Japan to finance third world development on a significant scale unless they are willing to accept that Japan must be permitted to run a trade or current account surplus in order to finance the deficit on capital account.

SUMMARY: Japan's economic growth rate has slowed from 10% p.a. in the 1950s and 1960s to between 3% and 4% p.a. today. The slowdown can be analysed in terms of reduced labour inputs and reduced capital inputs, but this seems at first sight to conflict with the fact that the savings rate in Japan has actually risen in recent years. However, the increased flow of savings has been absorbed to a significant extent by replacement investment (reflecting a larger existing capital stock), large government borrowings, and overseas investment. The prospects of Japan returning to a real growth rate in excess of 5% p.a. in future are negligible, but any reduction in the government deficit or a reduction in government expenditures as a percentage of GNP will assist in maintaining a high rate of investment in plant and equipment by the corporate sector, and will maximise Japan's growth potential.

SINGAPORE

THE BALANCE OF PAYMENTS DETERMINES MONETARY GROWTH

Despite the overall decline in world trade Singapore achieved a very respectable growth rate of 6% in 1982. However this was directly attributable to the strength of the domestic economy (see AMM Vol. 6 No. 3) and in particular the construction sector, which grew by 35% in 1982, and the financial services sector, which grew at a 16.8% rate. The relatively high overall growth rate masked a sharp decline in industrial production for the year. The index of manufacturing production in the fourth quarter of 1982 was down 11.2% from a year earlier.

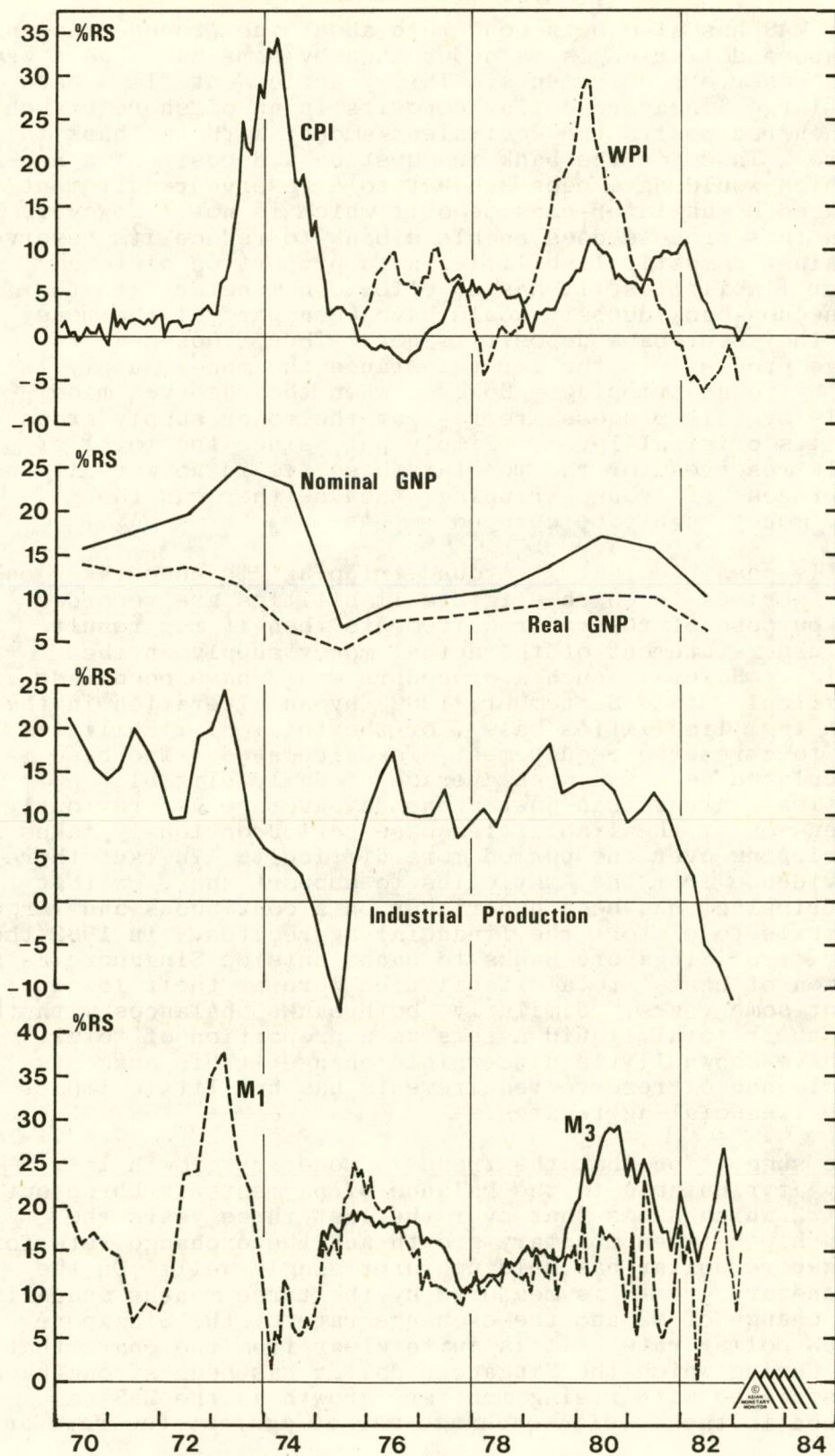
Liquidity in the economy, as measured by monetary growth less inflation, was generally very easy last year. Monetary growth, as measured by any aggregate, accelerated sharply from the trough reached in April 1982 (8.3% year-on-year for M2) to a peak of 19%-20% in October. This was at a time when inflation was falling rapidly to the point where, now, the underlying rate of inflation is zero. Easy liquidity emerged in the form of a booming stock market, the Straits Times Index having risen 56% by the end of March from its August low, but failed to result in a weaker currency.

The reason that a rapid acceleration in monetary growth last year went hand-in-hand with a generally firm currency (at least when compared to non-US dollar currencies) can be found in the record overall balance of payments surplus and the unwillingness of the Monetary Authority of Singapore to allow the Singapore dollar to appreciate for fear of damaging the international competitiveness of domestic industry.

Although the trade deficit showed some further deterioration from the previous year - to US\$7.4 bn - the overall balance of payments showed a surplus of US\$1.21 bn. This is explained by a growth in service receipts (tourism, banking) and a continued high rate of capital inflows. Over the past two years the MAS has been concerned that a high level of net capital inflows and receipts from services would 'crowd-out' the manufacturing sector from the balance of payments via an appreciation of the exchange rate. This concern was particularly evident last year when the manufacturing sector was undergoing a sharp contraction due to the impact of world recession.

Consequently in 1981 and 1982, at times when foreign exchange inflows were at a high level and hence demand for Singapore dollars particularly strong, the MAS allowed the exchange rate to firm somewhat but intervened in the market to sell Singapore dollars to prevent any currency appreciation becoming too great. Such intervention, as a purchase of foreign currency from commercial banks, results in an increase in the MAS' reserves and a corresponding increase in the banks' balances at the MAS - part of the monetary base. Thus a multiple expansion of the money supply follows, and in this

SINGAPORE
CHART 1 : MONEY, OUTPUT AND PRICES



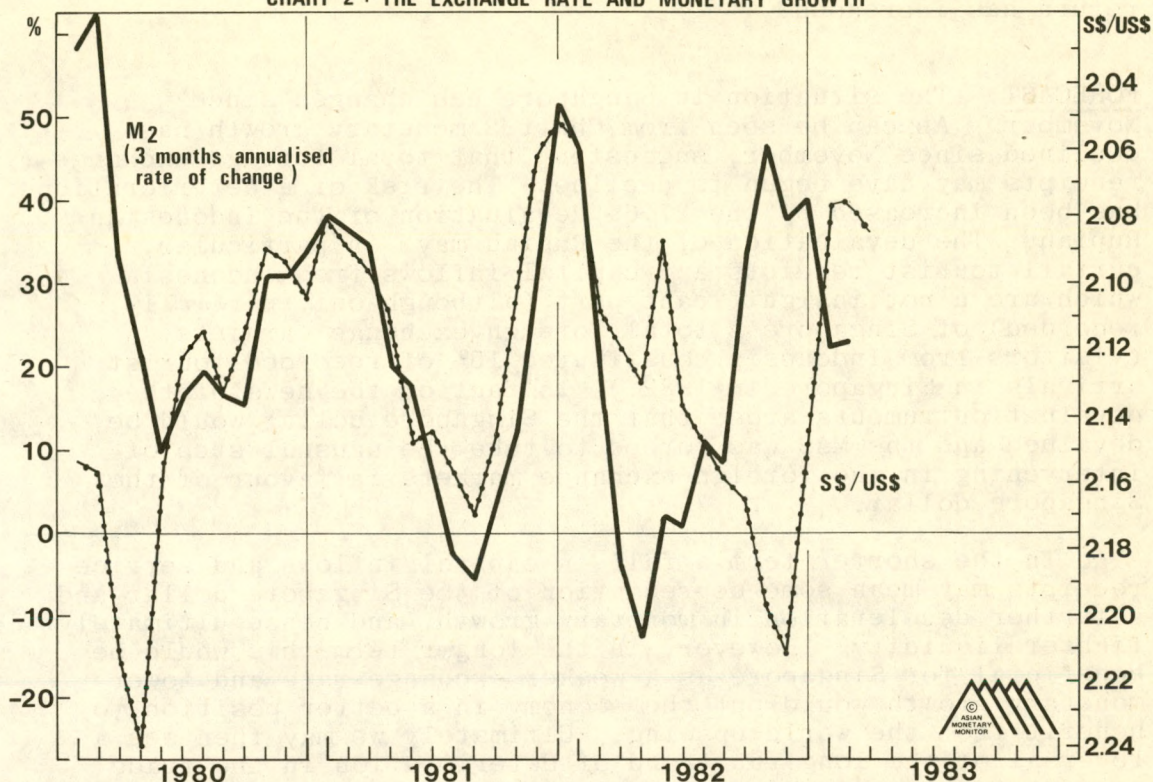
case a firm currency will be associated with rising monetary growth and a weak currency with falling monetary growth.

The MAS has also been concerned about the 'round-tripping' of Singapore dollar deposits undertaken by some banks as a way to avoid reserve requirements. This practice entails a bank booking large Singapore dollar deposits in an offshore branch which then redeposits the equivalent amount with the bank in Singapore. Thus for the bank in question a deposit of a non-bank, which would have been subject to a reserve requirement, is replaced by an inter-bank deposit which is not. However, although this process does enable a bank to reduce its reserves held against domestic liabilities as a proportion of total assets or liabilities, it has no effect on monetary growth. While the non-bank deposit would have been part of the money supply, the inter-bank deposit is not. Thus, looked at as a two stage process, in the first instance the money supply is reduced by round-tripping. However when the reserves made available by this process are re-lent the money supply grows back to its original level. Simply put, since the total of available reserves, or the monetary base, is in no way altered by the process of 'round-tripping' then neither can the recorded money supply be changed.

It is possible that if 'round-tripping' is undertaken only over the periods in which eligible liabilities are recorded for the purpose of reserve requirements then it may result in some understatement of the actual money supply in the statistics. However, such a procedure would have been made more difficult since September, 1982, by an alteration in the way in which the 'liabilities base', or the total of liabilities subject to a reserve requirement, is calculated. The base is now calculated as a two week average of daily eligible liabilities, rather than just a one day average as previously. The extension of the liabilities base period obviously makes round-tripping over the period more difficult. In fact there is no evidence from the statistics to support the view that 'round-tripping' has been undertaken on a continuous and large enough scale to distort the financial aggregates. In 1982 the liabilities of Singapore banks to banks outside Singapore as a proportion of banks' total liabilities were at their lowest level for some years. Similarly, both banks' balances with the MAS and their total liquid assets as a proportion of total assets have shown little discernible change. This suggests that avoidance of reserve requirements has had little impact upon the financial aggregates.

The suggestion that the trend in monetary growth is actually attributable to the balance of payments is borne out by Chart 2 which shows that over the last three years the relationship between monetary growth and the exchange rate for the Singapore dollar has held up surprisingly well. On the chart monetary growth is measured by the three months annualised rate of change of M2 and the exchange rate by the Singapore dollar/US dollar rate. It is quite clear from the chart that periods during which the Singapore dollar has been strong have been associated with rising monetary growth as the MAS has intervened in the foreign exchange market against the rate and supply

SINGAPORE
CHART 2 : THE EXCHANGE RATE AND MONETARY GROWTH



Singapore dollars to the market. Conversely, periods when the Singapore dollar has been weak have been associated with falling monetary growth as no intervention has been necessary. Although the relationship appears to go awry from April 1982, it must be remembered that this was the period of exceptional US dollar strength and against the yen, for instance, the Singapore dollar actually appreciated by 7.5% between April and October and was generally firm against most currencies.

The trends in the exchange rate and monetary growth can be tied in quite well with the trade account. For instance the rapid decline in monetary growth and weakness in the exchange rate in the first quarter of 1982 occurred when the trade position deteriorated sharply, from a deficit of US\$1.60 bn in the fourth quarter of 1981 to a deficit of US\$2.17 bn in January to March 1982. After that, the acceleration in the money supply was associated with an improvement in the trade account as import growth fell sharply in the wake of the deterioration in the manufacturing sector of the economy.

However, the most important factor determining swings in the overall balance of payments is probably capital flows. Net inflow of capital in 1982 was similar to the 1981 level at US\$2.3 bn but within this total there was a significant shift in composition as direct foreign investment declined and purely financial inflows increased. This improvement in purely financial capital may have been attributable to the problems in Hong Kong and Indonesia. After the recent, large, devaluation

of the Indonesian Rupiah the risk that some of this capital may return has increased.

FORECAST: The situation in Singapore has changed since November. As can be seen from Chart 2 monetary growth has declined since November, suggesting that total foreign exchange receipts may have begun to decline. The risk of a deterioration has been increased by the 27.6% devaluation of the Indonesian Rupiah. The devaluation of the Rupiah may, in particular, curtail tourist receipts and capital inflows from Indonesia which are a not insignificant part (although only partially recorded) of Singapore's total foreign exchange earnings. (Visitors from Indonesia constituted 15% of recorded tourist arrivals in Singapore in 1982.) In fact on the news of the devaluation rumours arose that the Singapore dollar would be devalued and the MAS was forced to take the unusual step of intervening in the foreign exchange markets in favour of the Singapore dollar.

In the shorter term a fall in capital inflows and service receipts may mean some depreciation of the Singapore dollar and a further deceleration in monetary growth, and hence ultimately tighter liquidity. However, in the longer term this would be beneficial for Singapore as a weaker exchange rate and lower monetary growth would put the economy in a better position to benefit from the world upswing. Ultimately we may then see a reversal of the long run trend of deterioration in the trade account and a return to export-led growth in Singapore.

TAIWAN

EASIER LIQUIDITY FUELS STOCK MARKET BOOM

In recent years, Taiwan's economy has been in the doldrums. From a cyclical high of 13.9% in 1978, real growth has declined in each of the last four years and measured only 3.8% in 1982. Whilst this performance compares favourably with that of most developed economies, it contrasts poorly with the boom years of 1976, 1977 and 1978 (see Chart 1) and, in this cycle, represents the most prolonged slowdown of any economy in the South East Asian region. Slower growth in the domestic economy has been accurately reflected on Taiwan's stock exchange where equity prices have been in a bearish trend for most of the past four years. However it is very likely that this bear market is now over. Taiwan's stock price indices have soared nearly 40% since the end of February amidst indications of a long awaited cyclical recovery in the Taiwanese economy.

The background to the prolonged weakness of Taiwanese stock prices is straightforward to explain. Throughout the 1970s the New Taiwan dollar was pegged to the US dollar with the result that the profile of Taiwan's business cycle closely followed that in the US. The US economy recovered strongly after the recession in 1974, producing a sharp deterioration in the US current account and a corresponding improvement in the balance of payments of those countries which pegged their exchange rate to the US dollar. The increase in Taiwan's current account surplus during 1976 and 1977 brought about a sharp rise in domestic monetary growth as the Central Bank of China (Taiwan's central bank) bought US dollars and sold NT\$ into the local money markets in order to maintain the exchange rate parity. This process was characteristic of nearly all economies which pegged their currency to the US dollar and brought about a strong recovery in Taiwan's economy which, with inflation running at only 1% to 2% during 1976, was competitively placed to take full advantage of the world upturn. In 1976, 1977 and 1978, Taiwan's economy expanded 13.5%, 9.9% and 13.9% respectively, in real terms. This underpinned a substantial rise in the local stock market which rose nearly 80% between January 1976 and November 1978.

The key feature of countries which peg the external value of their currency is the pronounced cyclical nature of real growth in their economies. Taiwan's experience during the 1976-1980 period was a fine example of the classical economic adjustment mechanism under a fixed exchange rate. The boom years (1976-1978), which were associated with a rising current account surplus, drew to a close as the external account began to move back to cyclical deficit.

The basis for the cyclical slowdown in Taiwan's economy was initially formed by a sharp rise in imports during 1978. Imports rose 27.9% during that year, after 12.2% during 1977, as the local economy boomed. Export growth, on the other hand,

remained fairly stable, with the value of exports rising 23.5% in 1978 after 20.4% in the previous year. Thus by the end of 1978 there were already signs that Taiwan's trade surplus was reaching a cyclical high and, under a fixed exchange rate regime, this also signalled the onset of the contractionary phase of the business cycle.

However, a number of developments combined to ensure that the cyclical downturn in this business cycle was especially prolonged and severe. The first of these was the Central Bank of China's decision to revalue the N.T. dollar from NT\$38 to NT\$36 in July 1978. This action was in line with other authorities' decisions to allow their currencies to appreciate against a fundamentally weak US dollar, but it exacerbated the deteriorating trend already evident in Taiwan's current account. The revaluation of the N.T. dollar also proved inappropriate in the light of the unexpected increase in oil prices during 1979. In order to maintain existing levels of real growth during 1979 and 1980 it would almost certainly have been necessary for the Taiwanese authorities to depreciate the external value of their currency in order to stimulate export growth and thus compensate for higher import costs. As it was, however, the value of imports soared 44.6% in the year to March 1980 whilst exports growth continued at around 20% - much in line with the growth rates of the prior three years.

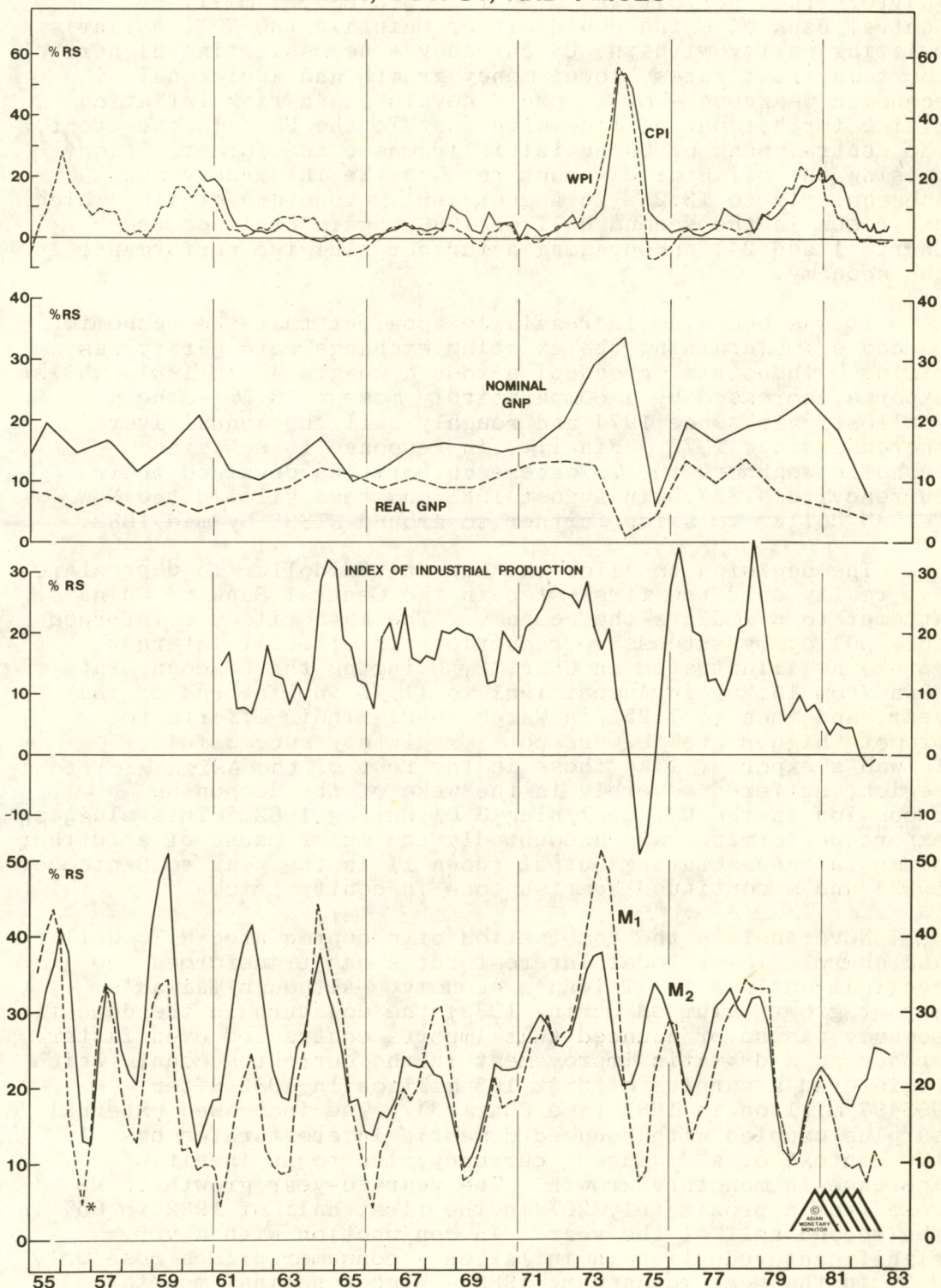
At the same time as Taiwan's external account was moving towards deficit, the Central Bank of China also raised domestic interest rates. The Central Bank of China had gradually reduced its discount rate from 12.0% in December 1974 to 8.25% in June 1978 - which proved to be the low point in Taiwan's interest rate cycle - and by August 1979 the discount rate had been raised to 11%. This combination of a deteriorating trend in the current account and increased local interest rates induced a savage squeeze on monetary growth. The year-to-year growth in the monetary base plunged from 33.7% in December 1978 to 2.2% in the final quarter of 1979, whilst M2 growth was reduced from 33.1% to 9.5% over the same period. This precipitous decline in monetary growth occurred at the same time as inflation soared: consumer prices rose from 6.4% to 12.0% in 1979 and wholesale price inflation nearly doubled to 15.9%. Falling monetary growth whilst inflation is rising implies that real purchasing power must have been heavily squeezed during 1979 and, indeed, growth in Taiwan's industrial output fell from 24.9% in 1978 to 7.7% in 1980.

Against such an economic background it is hardly surprising that the Taiwanese stock market failed to make headway. It is important to note, however, that the Taiwanese recession began well in advance of the prolonged monetary squeeze starting in the US during the first quarter of 1981. By pegging its exchange rate with the US dollar, Taiwan's economy was destined to bear the full brunt of the US recession. Other countries - Japan is perhaps the best example - partially insulated themselves from the full impact of the US recession by allowing their currencies to depreciate against the US dollar, thereby enabling themselves to exercise a degree of autonomy over their domestic monetary policy. The Taiwanese authorities, however,

TAIWAN

CHART 1

MONEY, OUTPUT, AND PRICES



* Change of data series.

% RS — Percentage Rate of change over
Same period of preceding year.

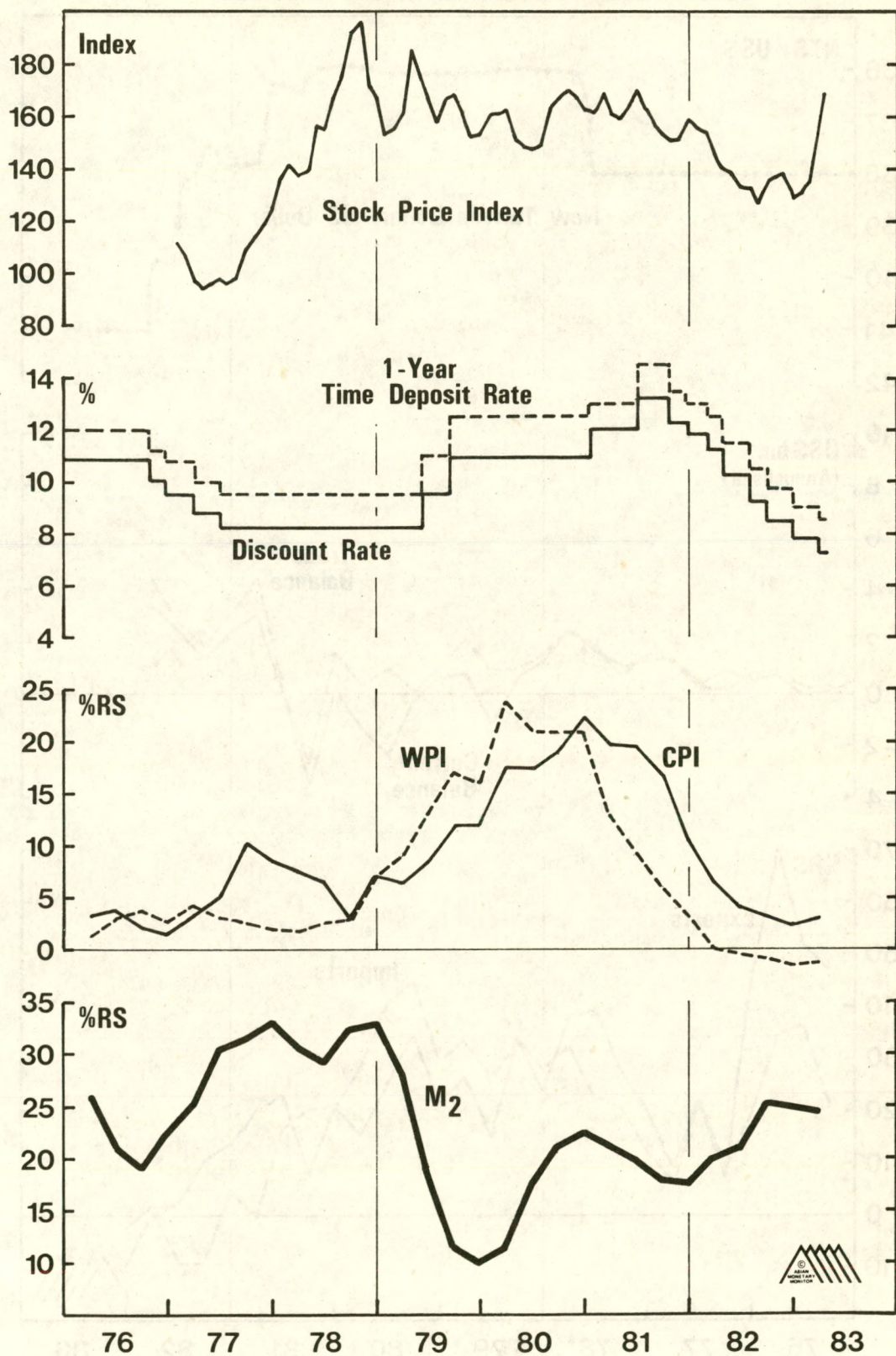
were faced with a difficult decision at the start of 1981. The domestic economy was weakening, yet consumer price inflation remained high (20.7% in the year to March 1981) and the first quarter trade deficit was a near record US\$527 million. The Central Bank of China could either maintain the N.T. dollar's existing parity with the US currency - necessitating higher short interest rates, lower money growth and additional economic weakness - or it could devalue, and risk inflation rising further out of line with that in the US. In the event, the Central Bank of China initially chose the former option, raising the official discount rate to 12% in January and subsequently to 13.25% in August 1981. Monetary growth, which had risen in the second half of 1980, again declined (see Charts 1 and 2), encouraging a further sluggish performance in the economy.

It was becoming increasingly apparent that the economic burden of maintaining the existing exchange rate parity was rising. Industrial production rose a meagre 4% in 1981, whilst exports increased by a comparatively modest 13.8% - the smallest gain since 1974 and roughly half the annual average increase since 1975. Finally, in response to sustained economic weakness the Taiwanese authorities devalued their currency to NT\$37.5 in August 1981 and then allowed the New Taiwan dollar to slide further to around NT\$39 by mid 1982.

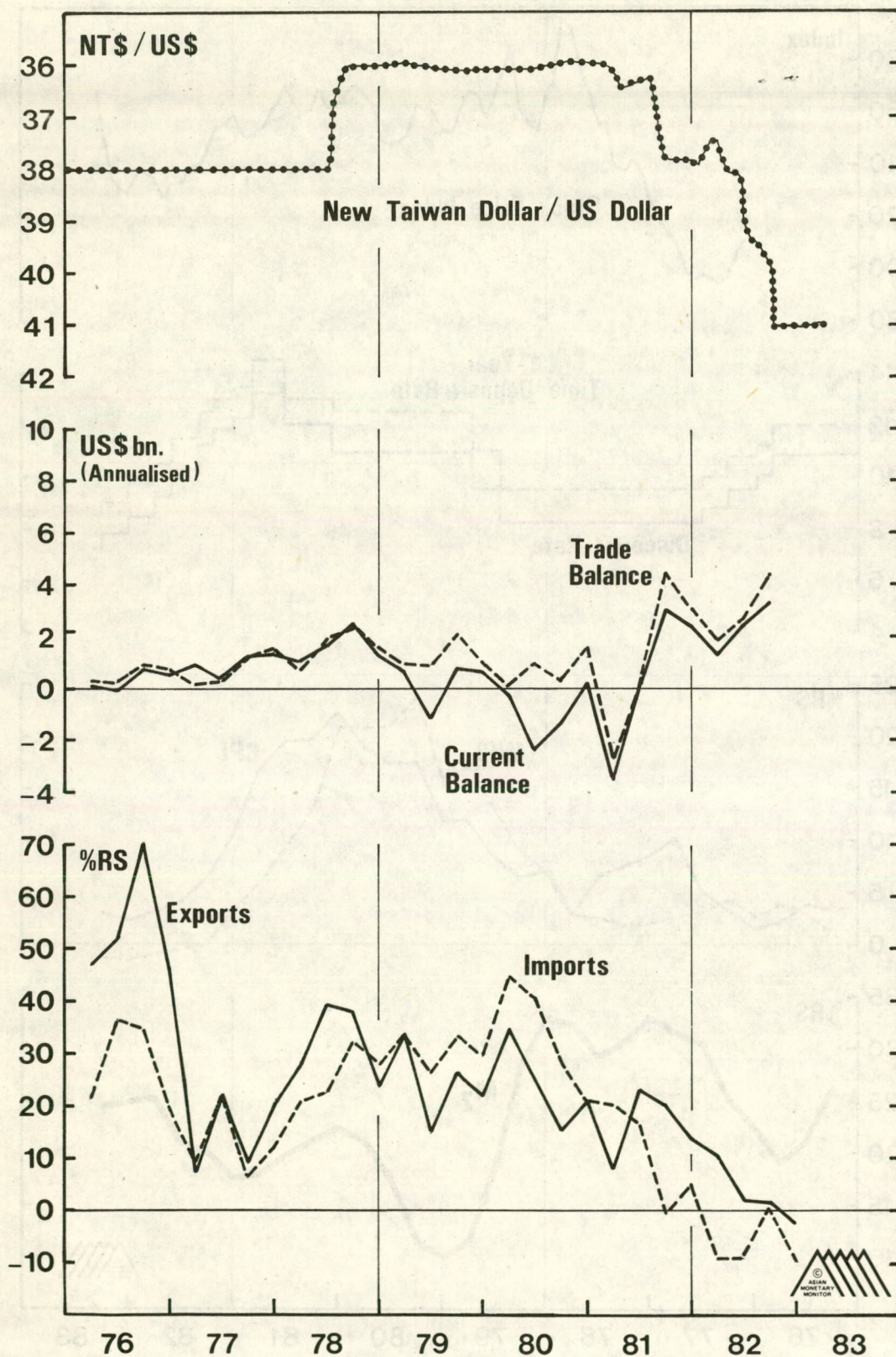
The decision to allow the New Taiwan dollar to depreciate was really only the first step in the Central Bank of China's attempt to stimulate the economy. The authorities reinforced this policy by successive reductions in official interest rates, as illustrated in Chart 2, bringing the discount rate down from 13.25% in August 1981 to 11.75% by the end of that year, and then to 7.25% in March 1983. Their efforts to promote higher growth were not immediately successful. Taiwan's exports, like those in the rest of the Asian Pacific region, suffered severely in the wake of the deepening recession in the US, declining 3.0% during 1982. This sluggish export performance was undoubtedly the major cause of a further slump in manufacturing output (down 1% in the year to September 1982) and a continued bearish tone in equity prices.

Nevertheless the combination of a depreciated N.T. dollar and sharply lower local interest rates has transformed the cyclical outlook for Taiwan's economy. Although Taiwan's export growth slumped during 1982, the downturn in the domestic economy was so pronounced that imports contracted even faster, producing a dramatic improvement in the current account, which registered a surplus of US\$2,193 million in 1982 after US\$497 million in 1981 (see Chart 3). The increased external surplus coupled with reduced domestic interest rates has, in the context of a "managed" currency, led to an inevitable increase in monetary growth. The year-to-year growth in M2 rose from approximately 20% in the first half of 1982 to 25% in the second half of the year. In conjunction with a very significant reduction in inflation - consumer prices rose only 2.2% in the year to January 1983 - higher nominal monetary growth has induced a strong rise in real purchasing power. In due course, this is very likely to translate into rising industrial production and a strong recovery in the economy.

TAIWAN : CHART 2
LIQUIDITY INDICATORS AND STOCK PRICES



TAIWAN : CHART 3
THE EXTERNAL ACCOUNT AND EXCHANGE RATE

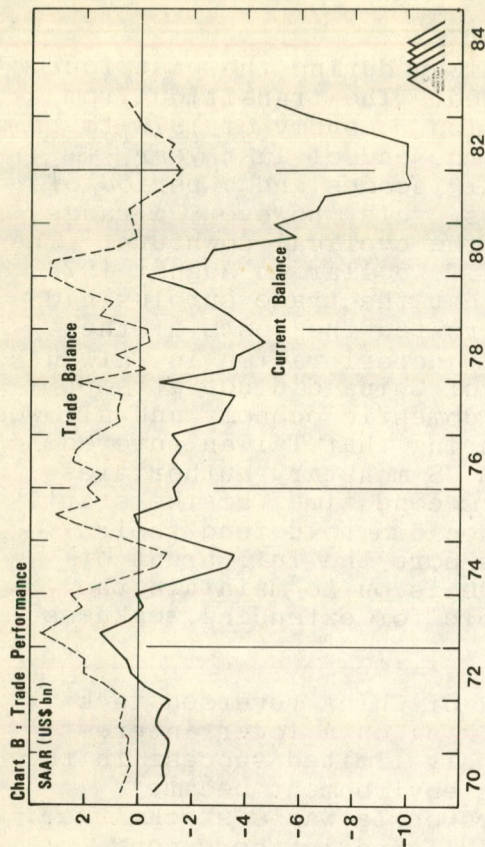
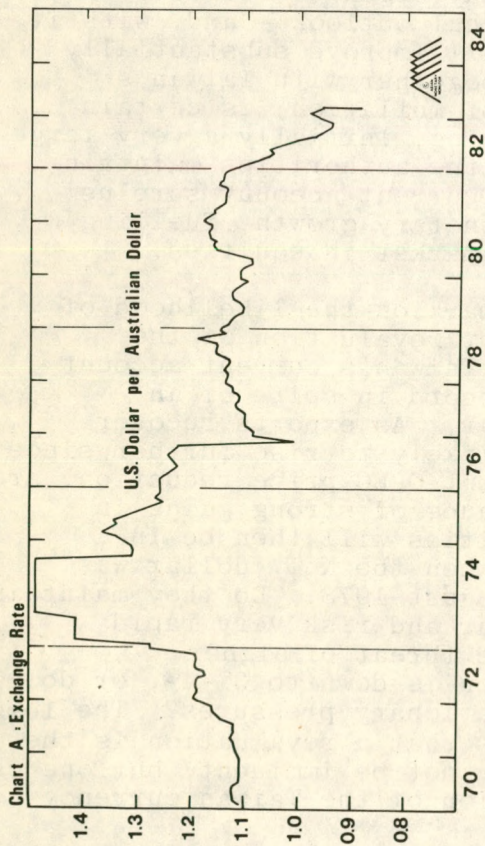


FORECAST: Economic adjustment in Taiwan during the past four years has been particularly protracted. The transition from the booming, potentially high inflation, economy of 1978 to the cyclically depressed economy of the end of last year inevitably required a squeeze on real incomes and a period of weakness in the stockmarket. In this cycle, however, a range of developments combined to prolong the cyclical downturn. The Taiwanese authorities revalued the N.T. dollar in August 1978, even though there were indications that the trade surplus had already peaked. This decision exacerbated the costs of the second oil crisis and created a swift deterioration in Taiwan's external account. The Central Bank of China did not attempt to offset the impact of this on the domestic economy and allowed interest rates to rise, thereby ensuring that Taiwan entered recession ahead of the US. When the US monetary authorities enforced a monetary squeeze for the second time, at the start of 1981, the Taiwanese authorities decided to defend their existing exchange rate. Taiwan thus bore the full brunt of monetary restraint in the US. The decision to maintain the NT\$36 parity was primarily responsible for extending weakness in Taiwanese equities.

In August 1981 the Central Bank of China reversed tack by devaluing the NT dollar and embarking on a lower interest rate policy. This policy met with only limited success in the first half of 1982, but the economic environment became increasingly favourable for investors on Taiwan's stockmarket. The easier liquidity conditions established in the second half of 1982 provided an essential base for a bull market in equities. The stockmarket has already begun to reflect this, but it is likely that Taiwan's cyclical outlook - and, with it, the outlook for the stockmarket - will improve substantially from here. The recovery overseas, together with Taiwan's depreciated currency and low level of inflation, is certain to stimulate Taiwan's exports producing, initially a very large current account surplus. Providing the authorities maintain a "managed" exchange rate a greater current account surplus will lead to further increases in monetary growth, fuelling both a domestic recovery and a bull market in equities.

As a footnote, one may also remark on the likelihood of either an appreciation or an outright revaluation of the NT dollar over the next two years. Taiwan's current account surplus is already the largest on record in spite of an absolute decline in exports last year. As exports recover this year, the external surplus is likely to rise further since imports, particularly after the recent OPEC price reduction, are unlikely to increase rapidly in advance of strong gains in local output. The Taiwanese authorities will then be in a similar position to February 1973 (when the N.T. dollar was revalued from NT\$40 to NT\$38) and August 1978. Do they maintain the existing level of the N.T. dollar and risk very rapid increases in monetary growth and the threat of higher inflation at a time when US inflation is down to 3%-4%, or do they revalue in order to limit inflationary pressures? The lesson from the last two business cycles is that a revaluation is the more likely choice. Such a move may not be imminent, but one can already see pressure for a revaluation of the Taiwan currency emerging over the next year.

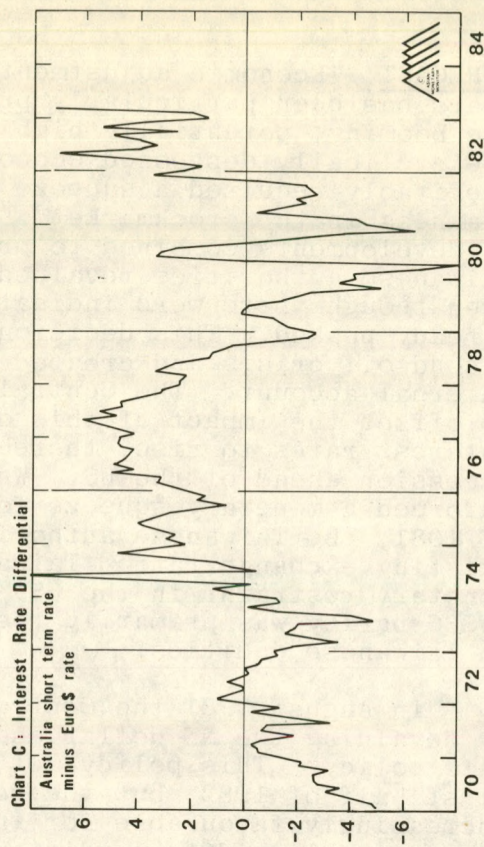
AUSTRALIAN DOLLAR



In spite of a 10% devaluation against the trade weighted index on March 8th it is still prudent to regard the Australian dollar as a fundamentally weak currency.

The devaluation has brought the US\$/A\$ exchange rate to approximately US\$0.86, suggesting (see Chart D) that the Australian currency is close to its sustainable long term value against the US dollar. Australia's recent trade performance also seems to lend support to the view that the Australian dollar is now fairly valued. The trade account has moved back to balance after nearly two years of deficit, and the current account deficit has narrowed. The improvement on the current account, coupled with a private capital inflow of A\$10.6 billion in the year to March, has led to a large increase in the level of Australia's international reserves which now measure A\$10.37 billion after A\$4.065 billion in March 1982. This, too, appears to argue against further weakness in the Australian dollar.

Nevertheless, there are strong reasons to expect further depreciation in the Australian dollar over the next year. First, Australia's actual and prospective inflation rate is now very high relative to that of its major trading partners. Second, the large



current account deficit leaves the Australian dollar vulnerable to any reduction in the level of private capital inflows.

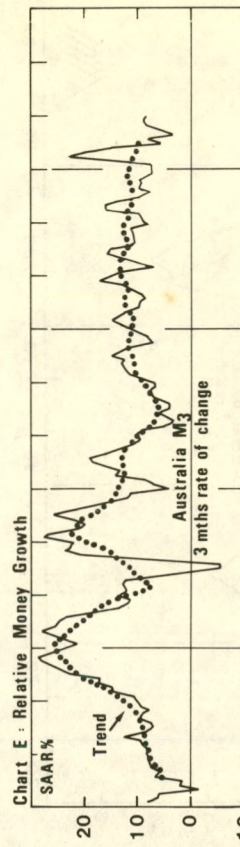
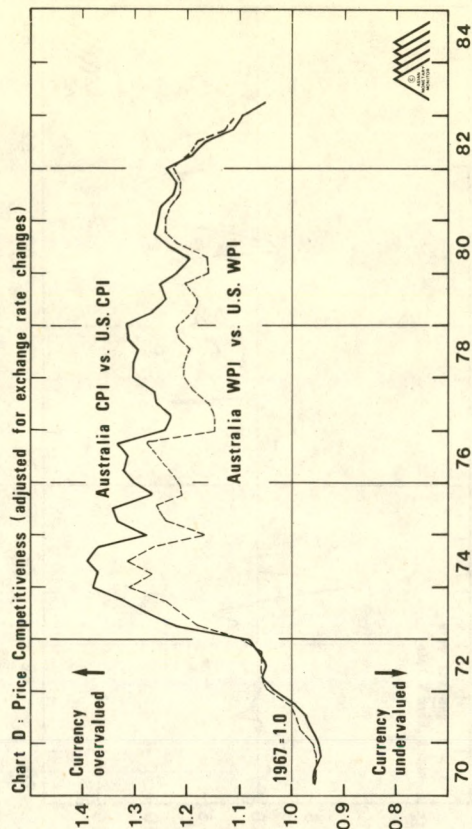
Consumer price inflation measured 11.1% in the year to December 1982. Chart E illustrates how M3 growth has remained in excess of 10% since 1978. Unless the Australian authorities move swiftly to reduce monetary growth the underlying rate of inflation is very likely to remain in excess of 10%, irrespective of whether or not the new Labour government implements a Prices and Incomes policy. In other words, unless the Reserve Bank effectively curtails excessive monetary growth in Australia, the competitive gains from the recent devaluation will quickly be eroded. Unfortunately, any policy designed to reduce monetary growth would be likely, in the shorter term, to raise local interest rates and prolong the current recession.

With Australia's unemployment rate now at 10.4%, there is a clear risk that the current government will not implement any policy that postpones an economic recovery. This implies that, given existing rates of inflation, any recovery in the Australian economy over the next six months can probably only be achieved in the wake of higher monetary and credit growth. Not only would this negate hopes of lower inflation over the course of 1983, but it presupposes that the Reserve Bank acts to reduce local interest rates and that it can do this without precipitating a reduction in private capital inflows. Thus, it seems, any attempt by the Australian authorities to foster a recovery in the local economy whilst inflation remains close to current levels is likely to be followed by further weakness in the Australian dollar.

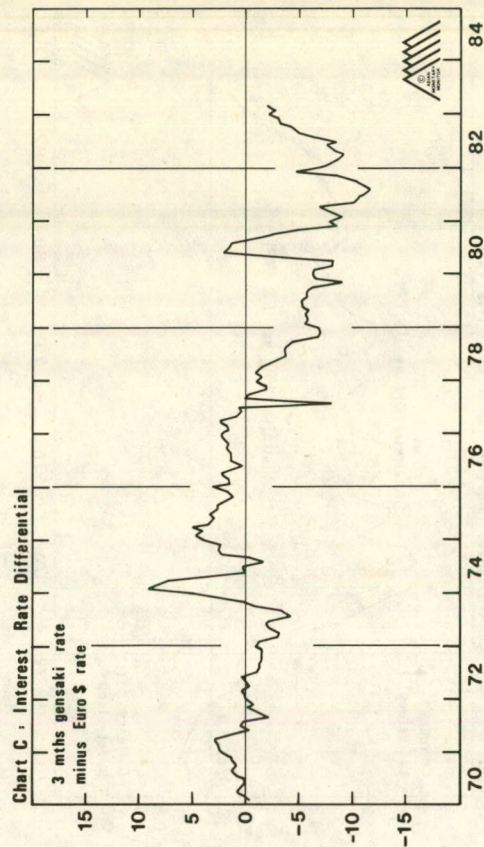
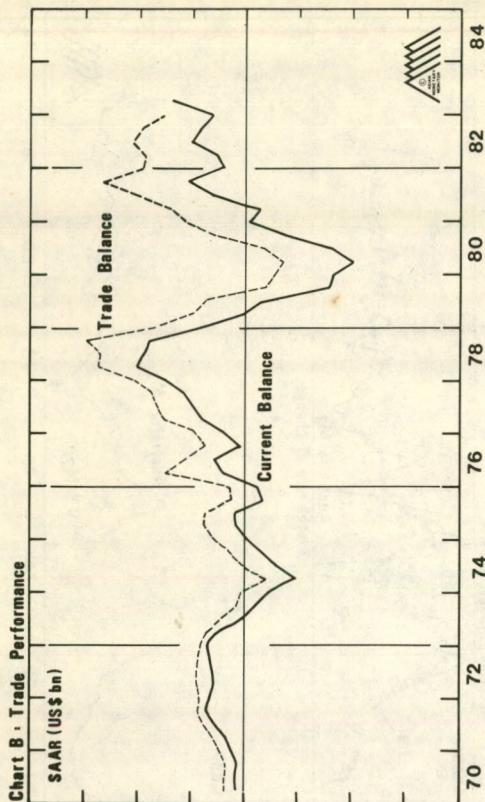
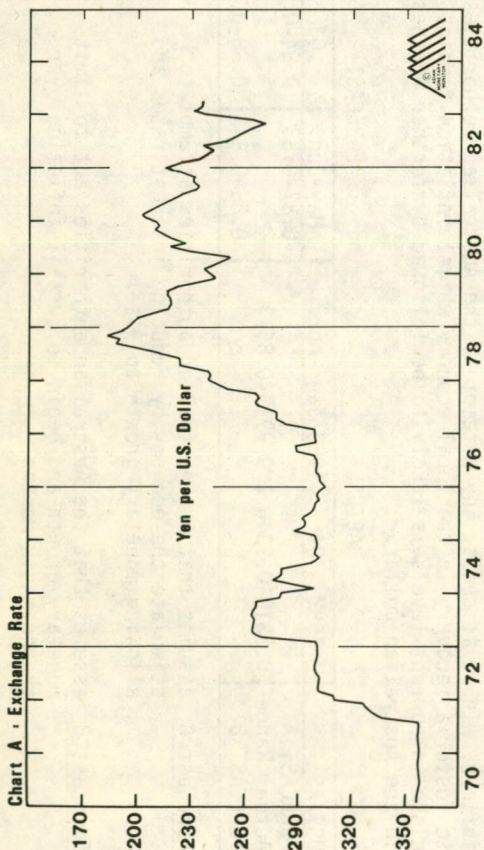
US\$/A\$	1982	Q4	1983 Jan.-Apr.	FORECAST	
				May-Jun.	Q3
FORECAST A				0.87-0.83	0.84-0.78
Actual Range	0.9810-0.9348	0.9913-0.8513			
FORECAST B				0.88-0.84	0.88-0.84

Forecast A assumes that the Australian authorities attempt to stimulate the economy by reducing interest rates and allowing monetary growth to rise.

Forecast B assumes that the Australian authorities act to limit monetary growth and begin to curtail inflation over the next six months.



JAPANESE YEN



The outlook for the Japanese yen is favourable during 1983. Fundamental considerations strongly suggest that the bull market in the Japanese currency which began in October last year will be resumed over the next six months, and that the yen's relatively narrow trading range against the dollar so far this year is best regarded as a period of consolidation before further strength.

The most obvious source of further appreciation in the yen lies with the likelihood of a strong improvement in Japan's current account. Chart B illustrates the slight deterioration in Japan's trade and current accounts during 1982 which, in spite of the yen's overall weakness, was mainly the result of a 13.4% decline in exports. This situation is likely to change dramatically in the second half of 1983. Whereas imports are likely to continue weak in response to lower oil prices and sluggish growth in the domestic sectors of the economy, one may confidently anticipate a revival in demand for Japan's exports as other OECD economies emerge from recession. Japan's current account surplus this year is likely to rival the record performance in 1978 and should provide strong support for the yen.

The trend in the Bank of Japan's current monetary policy - both in relation to previous policy (see Chart E) and relative to monetary

growth in the US - is also conducive to further strength in the yen. The Bank of Japan has gradually reduced M2+CD growth from around 10% in mid-1982 to 7.3% in the year to March, and has targeted a moderate 7.0% growth in this aggregate during the second quarter of this year. The Bank of Japan has therefore tightened its monetary stance at the same time as the US Federal Reserve has "eased up" by allowing M2 growth to accelerate from 9% in August 1980 to 12% now.

One symptom of the relatively easier monetary policy in the US compared with Japan is the narrowed interest rate differential (Chart C) between the two currencies. This, too, may lend support to the yen through its beneficial impact on flows of long term capital. However, a more important reason why slower monetary growth is likely to support the external value of the yen is that it implies that Japan is unlikely to share, to the same degree, in the economic recovery now underway in the US and Europe. This in turn suggests that the improvement in Japan's current account will be sustained for longer than would otherwise have been the case and augurs well for longer term strength in the yen.

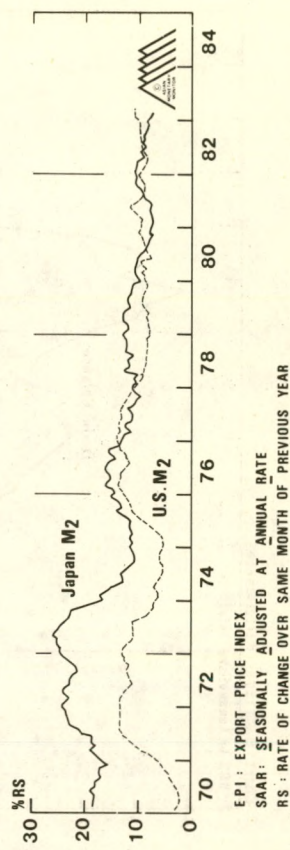
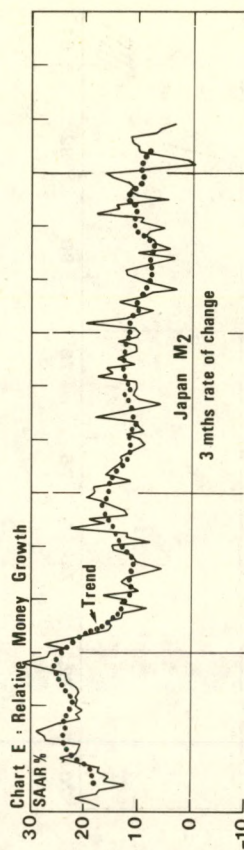
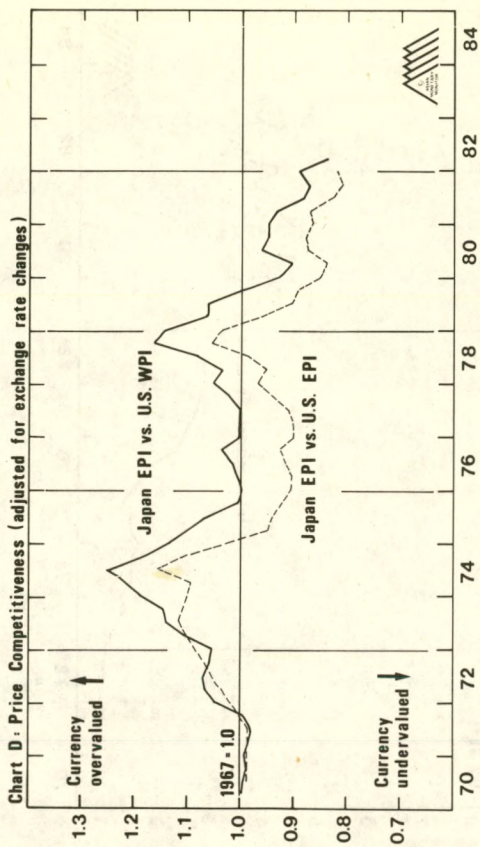
The main short term risk to the yen lies with the possibility that the Federal Reserve may return to a more restrictive monetary policy and thereby force US short rates to rise, if only temporarily. With US monetary growth currently well above target and signs that the US recovery may be gathering pace, holders of yen need to be aware of this risk.

ACTUAL FORECAST

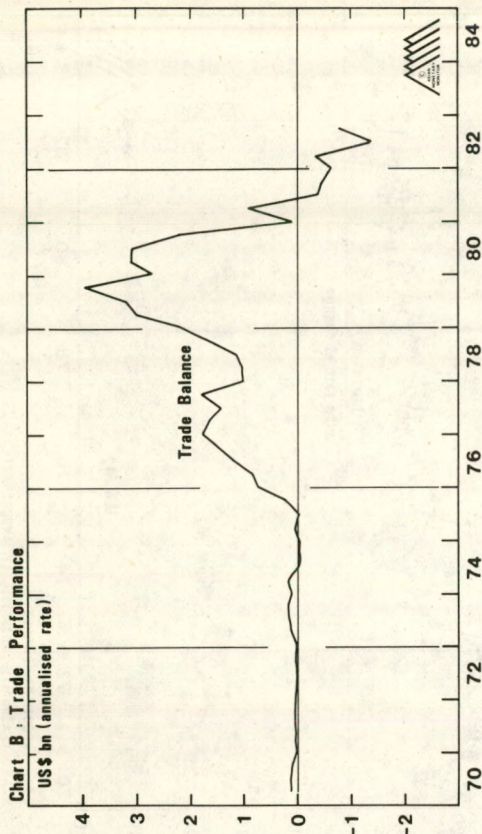
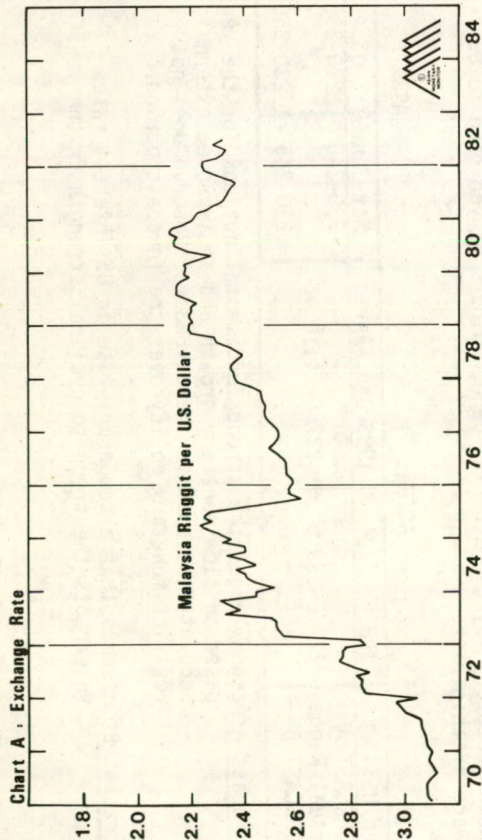
Yen/US\$	1982	Q4 1983	Jan.-Apr.	May-Jun.	Q3
FORECAST A				230-240	220-235
Actual Range	277.8-233.0	227.5-241.0			
FORECAST B				230-245	230-250

Forecast A acknowledges the strong fundamental outlook for the yen based on slow monetary growth and an improved external account, and assumes the US Federal Reserve does not restrict monetary policy over the forecast period.

Forecast B assumes that a temporary rise in US interest rates interrupts the trend to cyclical strength in the yen.



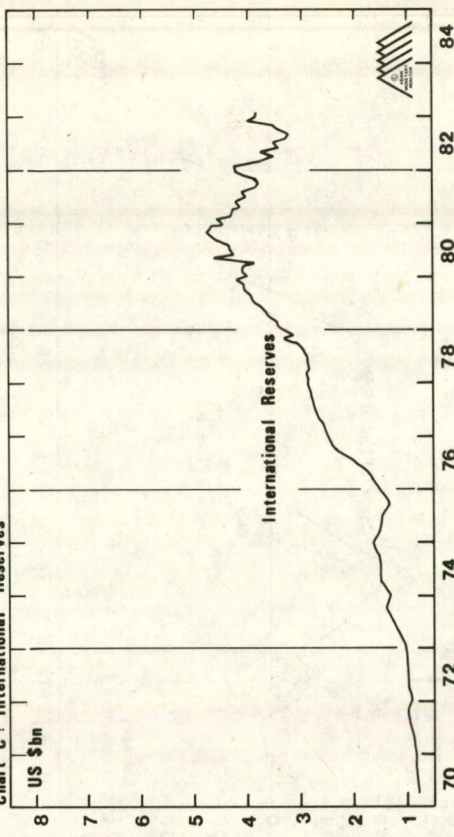
MALAYSIAN RINGGIT



No. 3) In our last exchange rate forecast for the Ringgit (AMM Vol. 6) we suggested that the important influences on the Malaysian currency would continue to be the trend in commodity prices and the level of official overseas borrowings. In 1982 the net effect of these two influences was that the Ringgit remained relatively firm against most currencies, despite the continued deterioration in Malaysia's terms of trade, as the level of government overseas borrowings remained high enough to finance a large part of the current account deficit.

The current account deficit deteriorated by over 50% last year, to US\$3.7 bn, as export growth fell and imports remained fairly buoyant due to the relative strength of the domestic economy. (The Malaysian economy grew by 4.6% in 1982.) Yet the government's counter-cyclical fiscal policy resulted in a budget deficit roughly equivalent to 18% of GNP which was partially financed by US\$1.72 bn of overseas borrowings. This level of borrowings, constituting a capital inflow on the balance of payments, prevented the deficit in the overall balance becoming too large and thus helped to support the currency. At the same time partial monetisation of the budget deficit through government borrowing from the Bank Negara Malaysia (BNM) offset the decline in the Central Bank's net foreign assets and

Chart C : International Reserves



enabled the money supply (M2) to grow 17.6% over the year (Chart E).

There is little reason why the Ringgit should not remain roughly at current levels over 1983. Despite government expenditure cutbacks the government's deficit is still projected at 14% of GNP, and the level of overseas borrowings is expected to be similar to last year. On top of this some improvement in the trade account may be expected as commodity prices become a little firmer. Both the rubber and tin price have risen from their lows at the beginning of the year, and the price of timber may be expected to undergo some recovery soon.

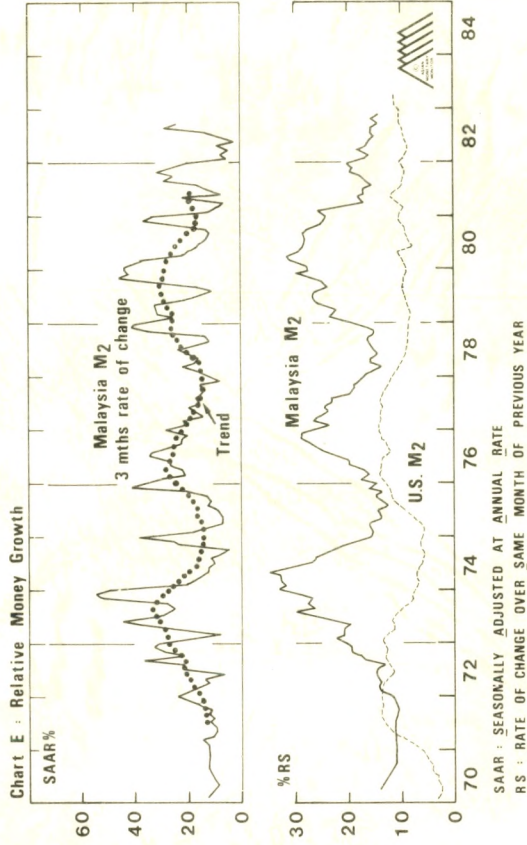
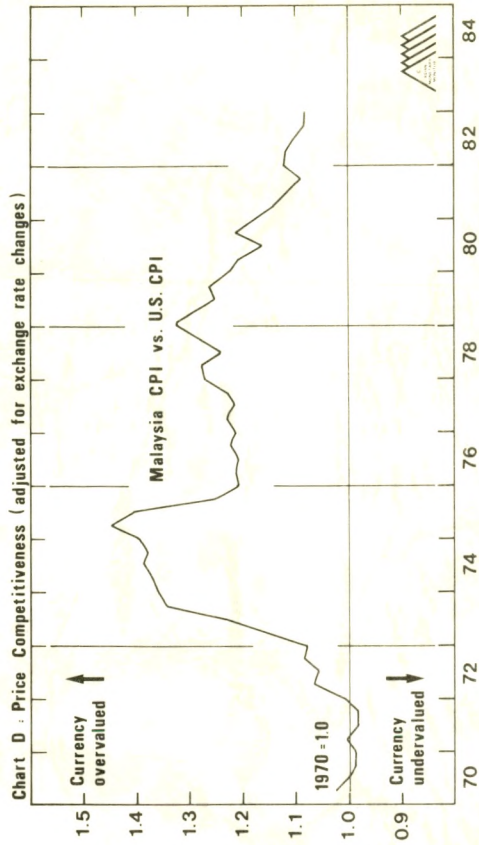
Indeed the trade account had already improved sharply in the fourth quarter of last year, moving into a surplus of M\$245 million for the three months. However, this was largely due to higher revenue from crude petroleum which cannot be expected to be sustained after the 15% cut in Malaysian oil prices in early March. The oil price cut represented a potential loss of US\$500m in export earnings for the year although this has been largely offset by increased production. Output of crude petroleum has now risen to 350,000 barrels per day compared to last year's average of 297,000 barrels per day. However, the price cut will have the effect of reducing earnings from Liquefied Natural Gas, the price of which is tied to the price of crude oil.

Inflation in Malaysia is down to 5.2% year-on-year. Chart D demonstrates that the Ringgit is not particularly overvalued, at least not when compared to the level of overvaluation obtaining over most of the 1970's. With a continued high level of government overseas borrowings and some improvement in the trade account we expect the Ringgit to remain in its present trading range over the foreseeable future.

M\$/US\$	ACTUAL			FORECAST	
	1982	Q4 1983	Jan.-Apr.	May-Jun.	Q3
FORECAST A				2.28-2.35	2.22-2.30
Actual Range	2.324-2.377	2.262-2.328			
FORECAST B				2.56	2.60

Forecast A is the most likely exchange rate in the absence of some major political or other external disruption.

Forecast B is based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate necessary to bring US and local price levels into line.

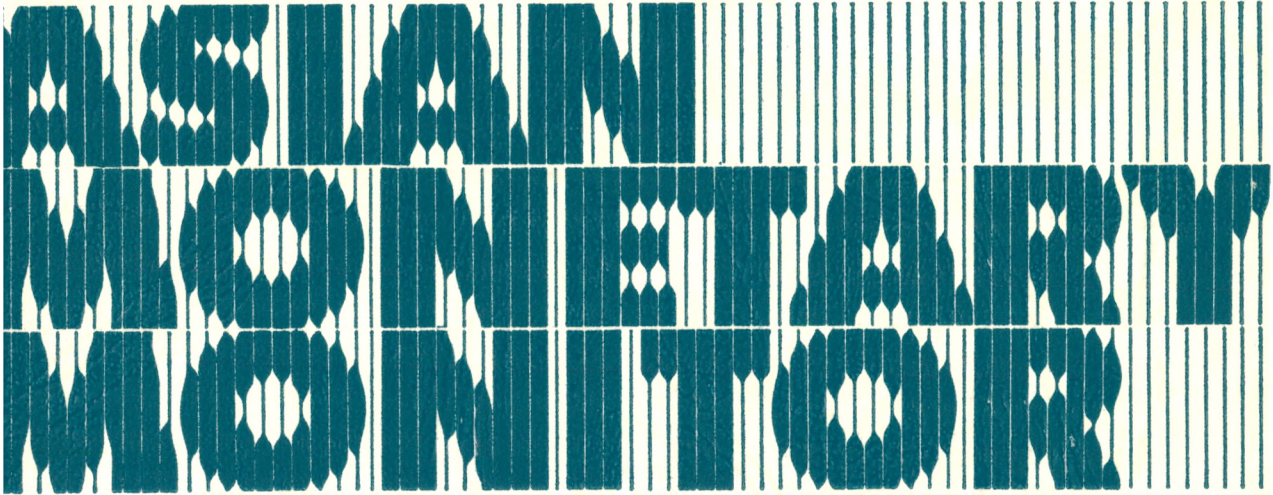




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

REGIONAL SURVEY

THE PATTERN OF ADJUSTMENT AHEAD OF US ECONOMIC RECOVERY

The US economy has reached the end of a prolonged period of adjustment following the boom of 1975-79 and is now in the initial stages of what promises to be a sustained recovery. Real GNP in the US has begun rising and is estimated to have grown at an annualised rate of 3.1% in the first quarter of the year. The two major reasons for believing that the recovery in the US can be sustained are, firstly, the significant improvements in productivity made over the course of the recession and, most importantly, the sharp fall in inflation that has been achieved as a result of the tight money policy pursued by the Federal Reserve over the period from October 1979 to the autumn of last year. Inflation has fallen from its early 1980 peak of 15% to 3½% year-on-year now. In addition, US monetary policy has become significantly more relaxed since October, providing an increase in real purchasing power to spur the recovery.

Apart from the US, European economies such as the UK and West Germany have also succeeded in reducing inflation and are in the process of recovery. If the industrialised countries now face a long period of strong economic growth then this will imply a recovery in world trade and a gradual improvement in commodity prices. Obviously this will be a very beneficial environment for the regional economies, which form the fastest growing area in the world. How well have the different regional economies adjusted to the world recession and low inflation environment and thus how well placed are they to take advantage of the recovery?

In a 'Regional Survey' in AMM Vol. 5 No. 6 (November-December 1981) we argued that the region faced a period of much slower economic growth in 1982 as it needed to adjust to the monetary explosion of 1979/80 which had led to an extended period of high economic growth and rising inflation in most of the region's economies. Indeed this is in general what has occurred, and following the monetary slowdown which began in most of the regional economies at the beginning of 1981, growth rates in 1982 dropped sharply. However, the extent of adjustment to the impact of world recession has varied between economies depending on differing domestic circumstances, and thus some of the region's economies are now better placed to take advantage of world recovery than others.

In monetary terms the most obvious difference between the region's economies lies in the different approaches to monetary management, particularly with regard to the exchange rate. In the region, approaches to the exchange rate vary from Thailand on the one hand which pegs its currency at a fixed rate to the US dollar, to, on the other hand, Japan and Hong Kong which allow a free float. The other major regional economies manage their exchange rates, to a greater or lesser extent.

Differences in the approach taken by the monetary authorities towards the exchange rate have direct implications for the adjustment process and this can be seen from a study of the regional economies' performance over the last year or so. If the monetary authority manages or fixes the exchange rate then changes in the balance of payments will impact upon the monetary base, and hence the money supply, and adjustment to external disequilibrium will occur through changes in the level of domestic economic activity, as opposed to movements in the exchange rate.

The commodity producing economy of Malaysia provides an example of a managed rate economy subject to large swings in its external balance. In 1979/80, the commodity price boom meant that Malaysia experienced a burgeoning trade surplus and a rapid acceleration in monetary growth. This was reflected in a strong economy, rising inflation into the middle of 1981, and buoyant imports. As commodity prices began to fall in 1981, export growth dropped and the trade account moved to deficit. Consequently, monetary growth fell and liquidity became tighter, leading to the economic slowdown in 1982.

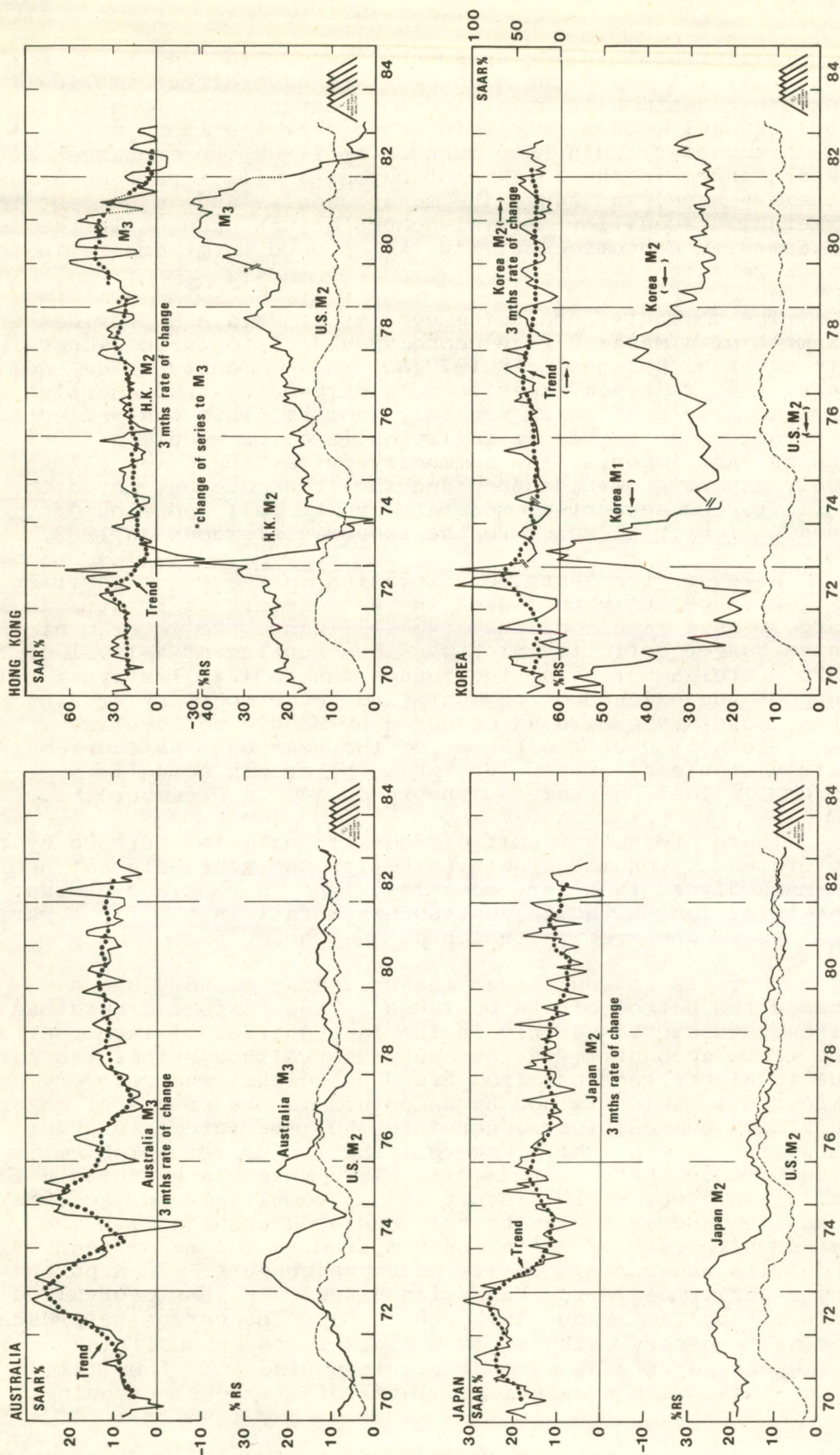
However, the sharp deterioration in the trade position failed to be fully reflected in the monetary aggregates in 1982 largely as a result of the need to finance the government's large budget deficit, which was then running at a level of 18% of GNP. Foreign borrowing to finance the deficit last year helped support the balance of payments and hence monetary growth. Thus, monetary growth as measured by M2 did not decline significantly over the course of the year but instead remained fairly stable at around 16%, while M1 growth actually rose (from 11% year-on-year in January to 14% in December).

Therefore as a result of domestic policies pursued by the government, economic growth (4.6% for the year) did not decline as markedly as in other economies, imports remained buoyant and inflation, although continuing to fall in the first part of last year, appeared to trough at just below 5%.

There is no doubt that the Malaysian economy has now passed the bottom of its business cycle. Export growth had already recovered sharply in the last quarter of last year and the trade account moved into surplus. Although this was partly due to higher receipts from crude petroleum, the recovery can be expected to be sustained by an upturn in the prices of major Malaysian commodities. Therefore the immediate future for Malaysia looks bright. However, the longer term problem is likely to be that, whereas since 1975 Malaysia has been a low inflation economy, it did not adjust completely to the 1981/1982 recession and is beginning this business upswing with a rather high rate of inflation compared to the major industrial economies and certain of its Asian neighbours. On a purchasing power parity basis the Malaysian Ringgit is less overvalued now than at any time since 1972 (Chart 3). The correct approach for the monetary authorities to take is to gradually appreciate the exchange rate as commodity prices rise. If they fail to do this, with a maintained level of overseas borrowings

CHART 1

RELATIVE MONEY GROWTH RATE IN THE ASIAN PACIFIC REGION



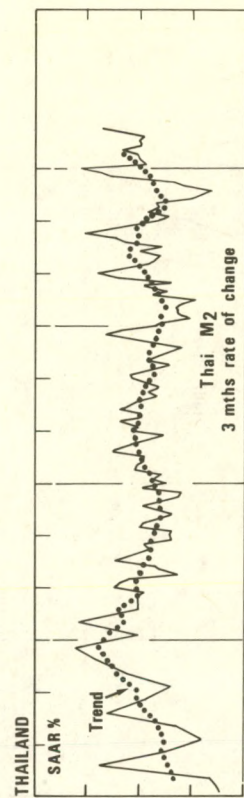
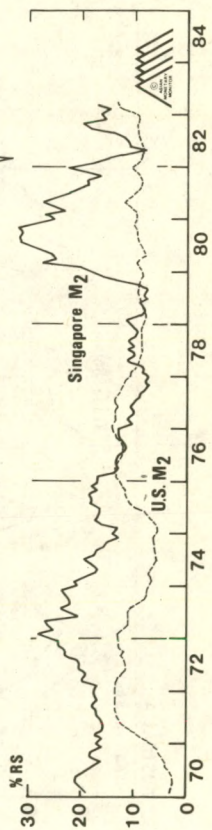
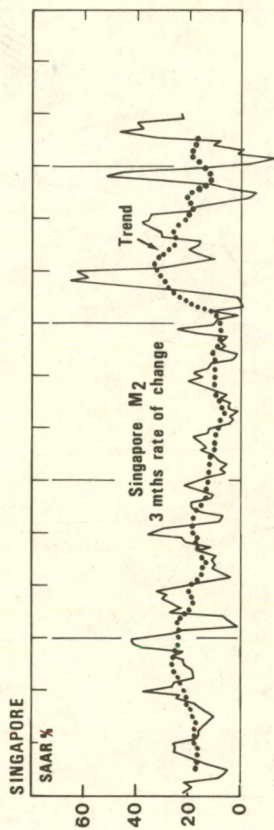
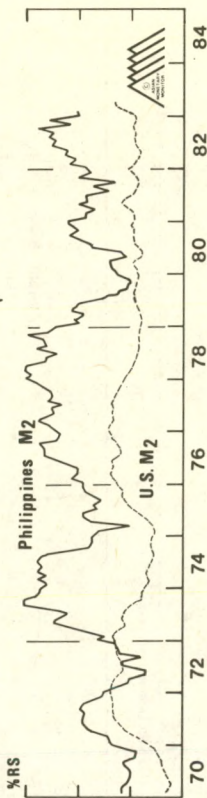
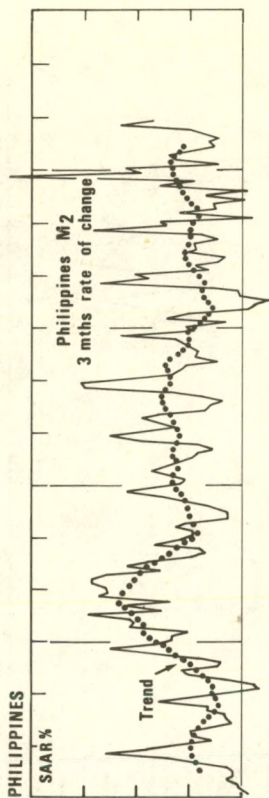
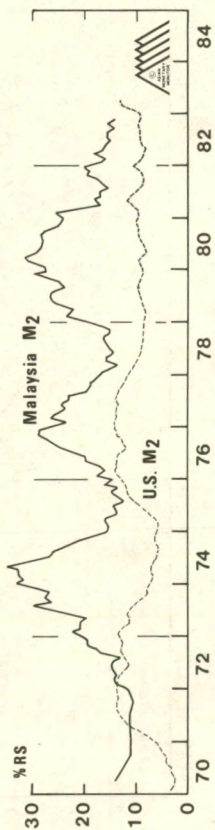
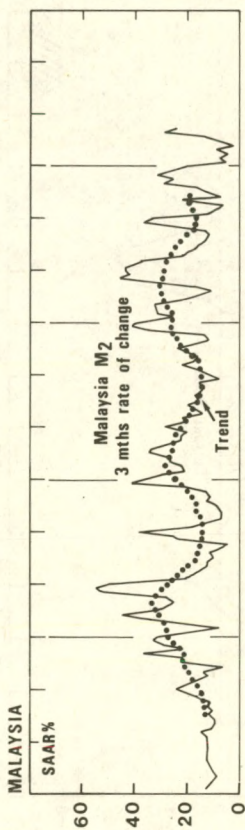
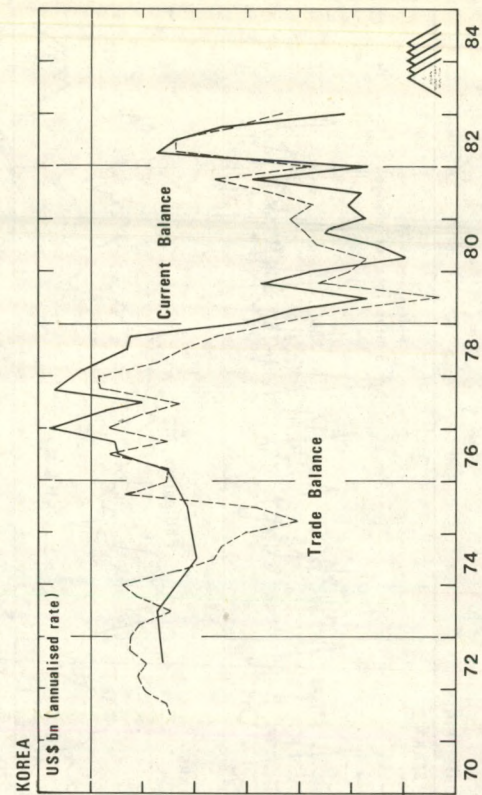
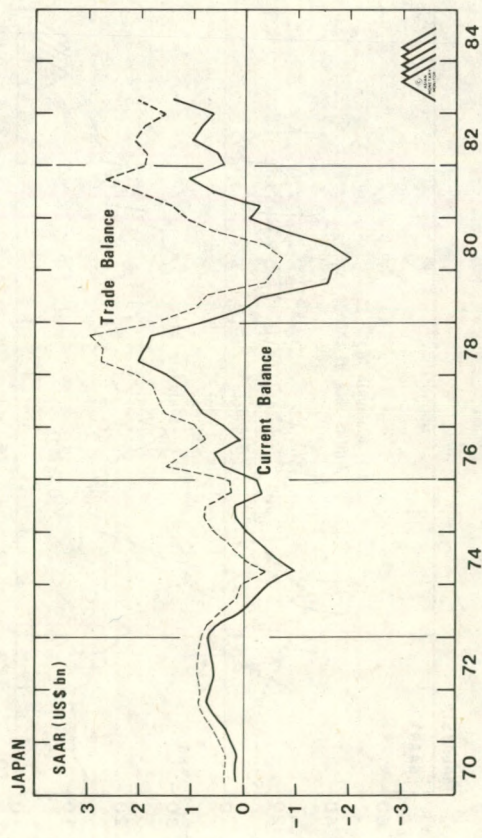
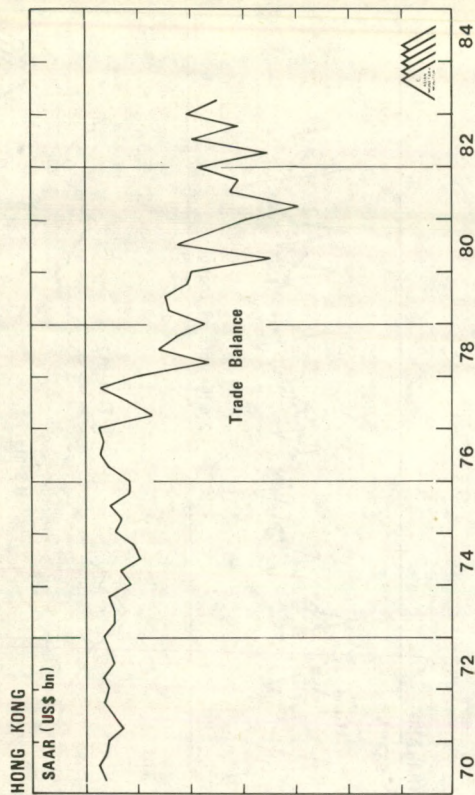
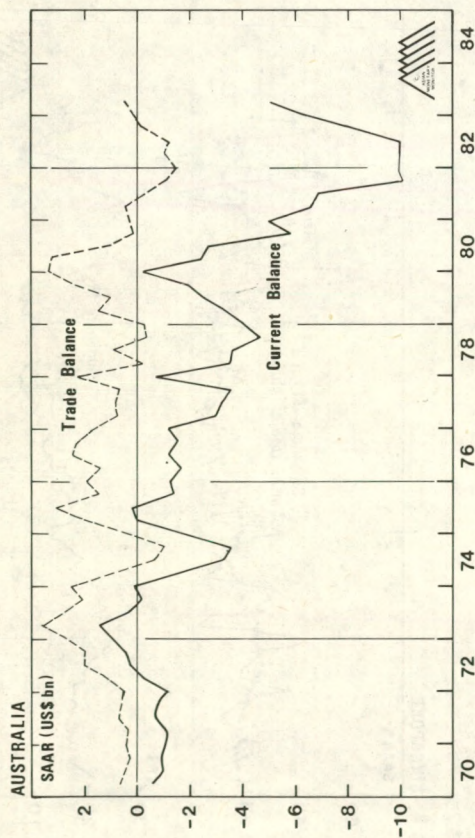
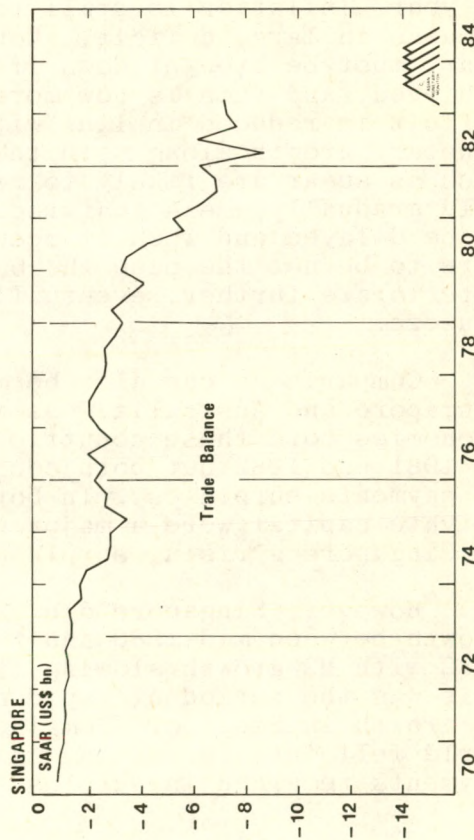
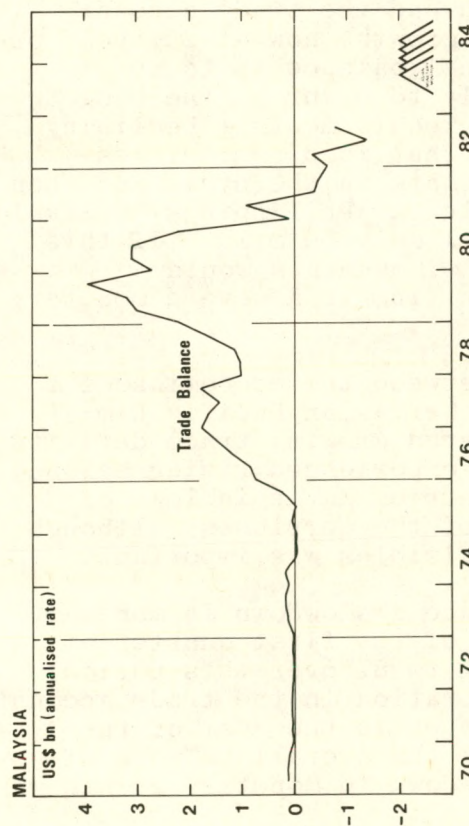
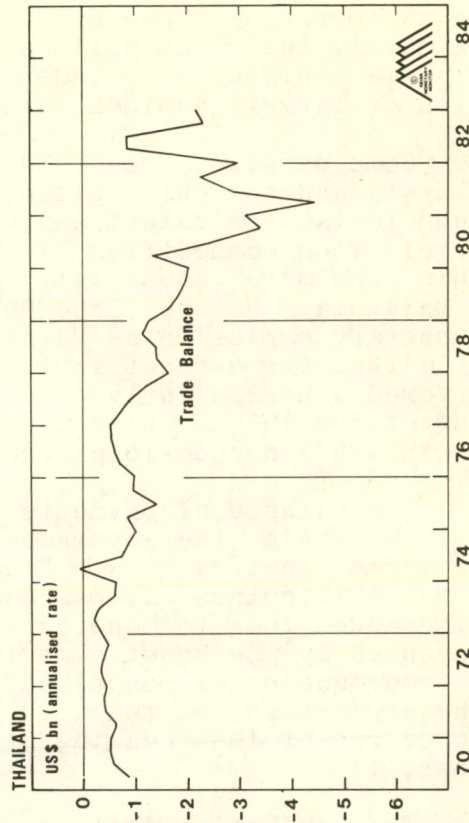
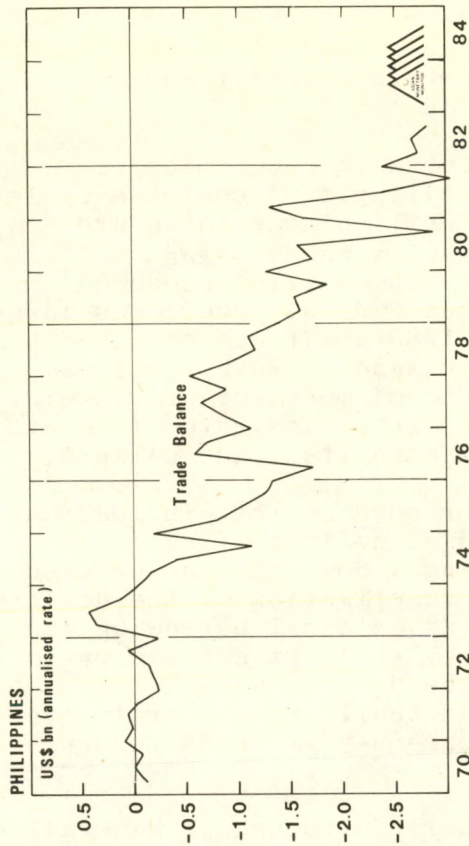


CHART 2 TRADE PERFORMANCES IN THE ASIAN PACIFIC REGION





and an improving trade account, monetary growth will rise and ultimately inflation will pass the peak reached in 1981. Then Malaysia would have to undergo the severe monetary squeeze which it largely avoided in this cycle.

Some parallels can be drawn between the economies of Malaysia and the Philippines. The Philippines' business cycle tends to lag the Malaysian cycle as Philippine exports are largely food commodities, in which cycles tend to lag behind the more industrially oriented commodities produced by Malaysia. However, the Philippines did not undergo as large a monetary explosion as Malaysia in 1980 as it did not enjoy any marked improvement in its trade balance. Rather, it has suffered a persistently excessive rate of monetary growth over most of the 1970's which has resulted in a high rate of import growth and a decade-long deterioration in its trade balance.

The balance of payments was in record deficit in 1982 but as in Malaysia, the government's budget deficit effectively prevented monetary growth from falling. However, in the case of the Philippines, it was domestic monetisation of the deficit which added fuel to monetary growth as external borrowing was prevented by the constraint imposed by the debt service ratio. The consequence of monetisation of the deficit was that monetary growth, as measured by M2, actually rose sharply over the course of 1982 peaking at 27% year-on-year in September (Chart 1).

Thus inflation fell only marginally although it has fallen in the first quarter of this year. However, at nearly 7% year-on-year, inflation is still too high and the trade account remains in large deficit. Monetary growth, now at 20% year-on-year, must be brought down if external balance is to be achieved, and this is now more likely to occur as the budget deficit is reduced in line with IMF requirements. Declining monetary growth along with the fact that food commodities such as sugar are likely to recover late in the cycle and then only gradually, mean that recovery in the Philippines is likely to be delayed and when it occurs will only be mild. If this were to be not the case the balance of payments would deteriorate further, eventually resulting in a severe monetary squeeze.

Comparisons can also be made between the economies of Singapore and Australia. As with other Asian Pacific Rim economies both these countries suffered growing trade deficits in 1981 and 1982 but both countries experienced rising balance of payments surpluses. In both countries large inflows of private capital were a major cause of the surpluses, although in Singapore a rising surplus on invisibles was important.

However, Singapore did experience a slowdown in monetary growth between mid-1980 and the end of the first quarter of 1982 with M2 growth slowing from 30% to 8% over this period. This was the period of rapid deterioration in the trade account as growth in Singapore remained high while the rest of the world fell into recession. Although the overall balance of payments remained in surplus, a slowdown in monetary growth was

possible as a result of the contractionary effect of the government's fiscal operations. Consequently, as real economic growth remained at close to 10% over the period of falling monetary growth, liquidity tightened, paving the way for a decline in inflation to the point where the underlying rate of inflation is now close to zero.

Due to a high level of financial capital inflows and increased earnings from financial services, in particular, the balance of payments was in record surplus in 1982. The monetary authorities were unwilling to allow the exchange rate to appreciate for fear of further damaging the manufacturing sector, and so the balance of payments surplus meant that monetary growth began to rise sharply from April, reaching 19%-20% by October. Although monetary growth has since begun to decline, with zero inflation liquidity remains easy, and with easy liquidity and a marginally undervalued exchange rate (on a purchasing power parity basis) Singapore is in a very good position to benefit from world recovery through export-led growth. The only caveat is that a decline in private capital inflows in the short term may tighten liquidity, but this would be a positive factor for Singapore in the longer run.

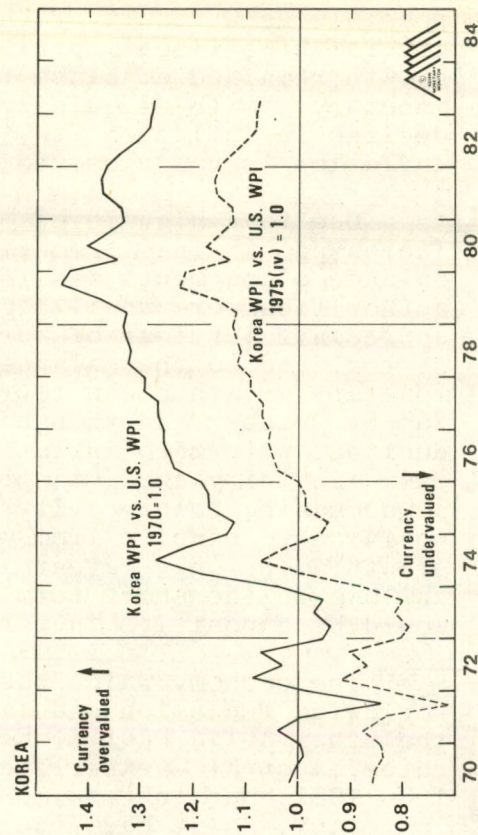
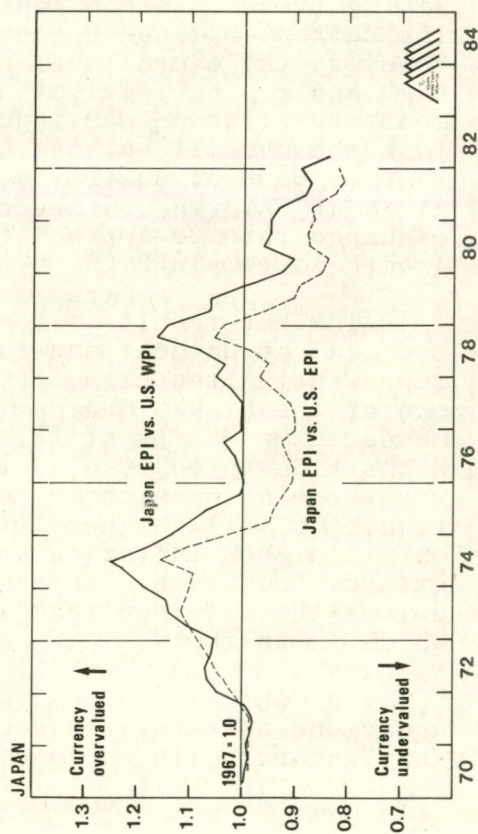
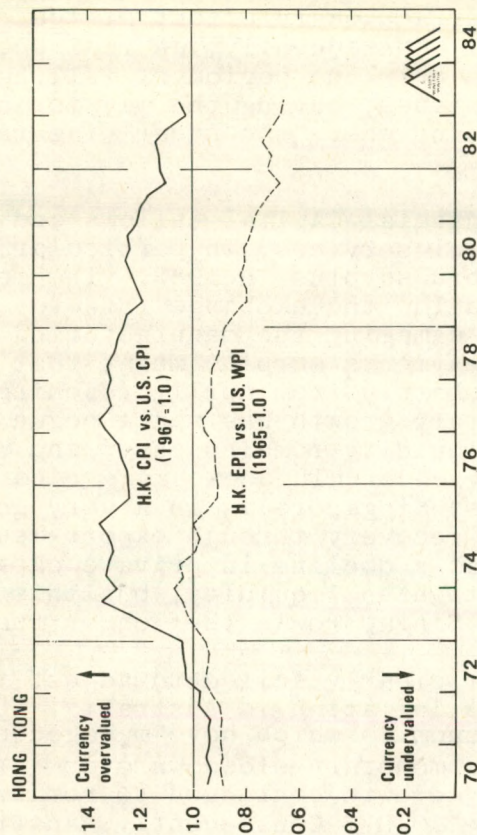
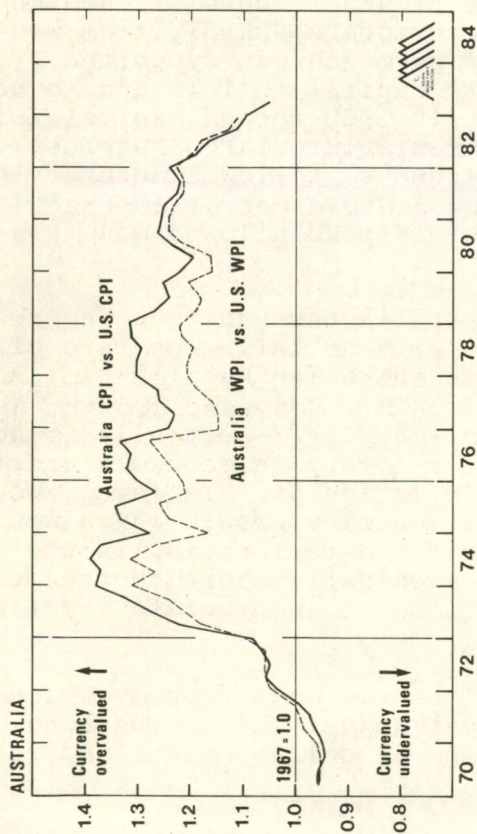
The economy which has most clearly failed to adjust to worldwide recession and falling inflation is Australia. Unlike the other Asian Pacific Rim economies which have managed exchange rates, Australia experienced no monetary slowdown over 1980/1981, but instead monetary growth continued to remain above 10%, as it had done since 1979. Consequently, Australia's rate of growth remained high and inflation continued on a rising trend. As one would expect under these circumstances, the current balance began to deteriorate sharply from mid-1980. However, the overall balance of payments was supported by a high and rising level of private capital inflows and so no monetary slowdown was induced. In 1982 record capital inflows took the overall balance of payments into large surplus. The Reserve Bank of Australia continued to follow a monetary policy aimed at lowering interest rates and did not allow the exchange rate to appreciate, but instead allowed monetary growth to remain high.

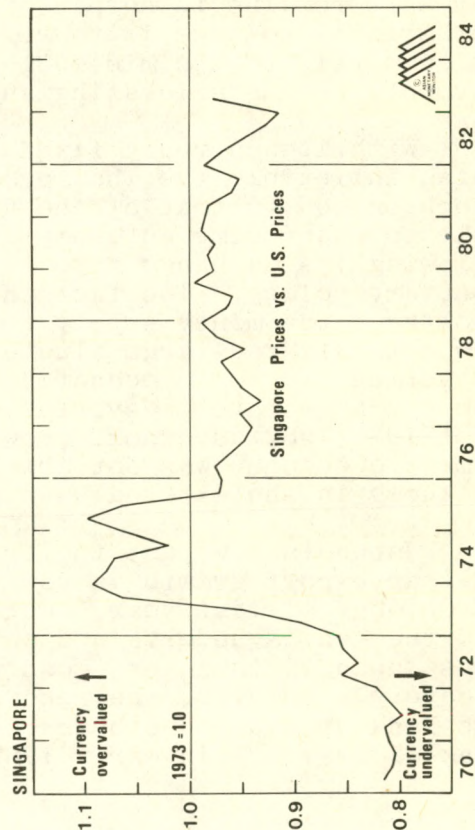
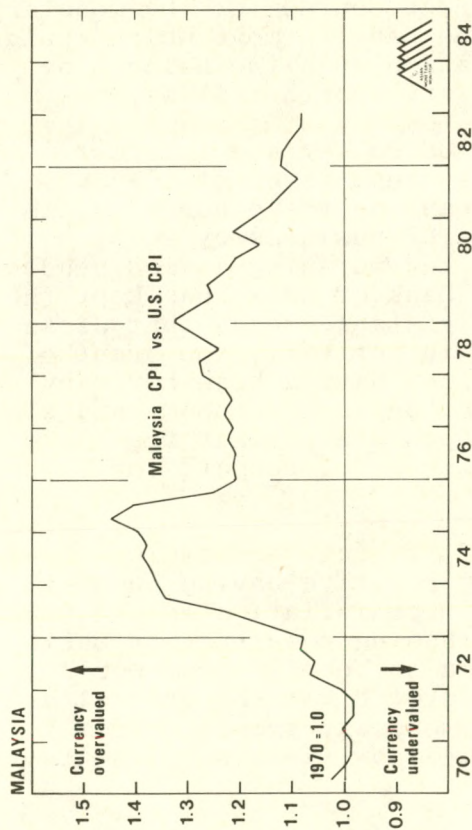
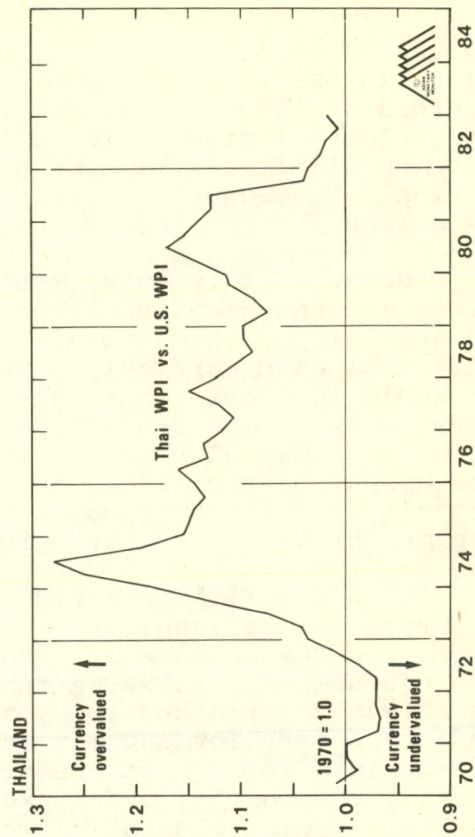
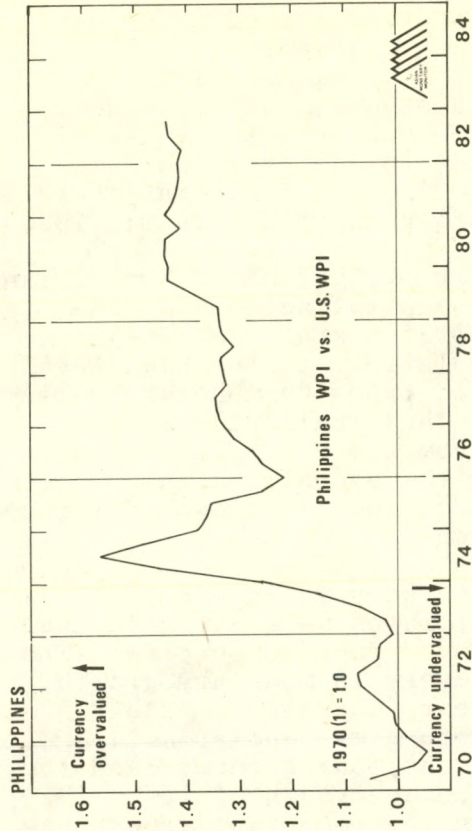
The net result is that Australia has undergone no real cyclical adjustment and is left with an inflation rate of 11.5% representing the highest rate in the Asian Pacific Rim and one of the highest rates in the OECD. Monetary growth, as measured by M3, is at 12.4% year-on-year. Australia is not in a position to enjoy a sustained recovery in economic growth. A recovery in the economy, with inflation at this level, would require a still higher level of monetary growth which would entail higher inflation and further deterioration in the external position. This would eventually abort the recovery - unless the exchange rate was allowed to depreciate indefinitely, which is unlikely.

In contrast to Australia, the regional economy which has undergone the most rapid cyclical adjustment is Thailand. As Thailand pegs its currency to the US dollar at a fixed rate one

CHART 3

PRICE COMPETITIVENESS (adjusted for exchange rate changes) IN THE ASIAN PACIFIC REGION





would have expected the economy to provide a good example of adjustment under a fixed exchange rate. This is indeed the case for as the balance of payments moved into deficit at the end of 1980, Thailand suffered a severe monetary squeeze which took M2 growth from 22% in December 1980 to 14% in November 1981, and M1 growth from 14% to -4% over the same period. Consequently, inflation declined to the point where it is now only 2.2% year-on-year (from a peak of 25% in mid-1980).

However, this adjustment was not brought about through the trade account so much as through the capital account of the balance of payments. Thai interest rates are relatively inflexible and were only adjusted belatedly to the high level of world interest rates that resulted from the monetary policy pursued by the US Federal Reserve. Thus Thailand suffered large outflows of private capital from the end of 1980 and throughout most of 1981, which took the overall balance into deficit over that period, hence, under the fixed exchange rate regime, bringing monetary growth down.

With the fall in world interest rates in 1982 capital returned to Thailand, where interest rates were now relatively high, and the balance of payments moved back to surplus. The consequence of this was a rapid recovery in monetary growth, which has now reached 25% year-on-year (Chart 1). With inflation very low and monetary growth high conditions are appropriate for a rapid recovery in the Thai economy, and the economy must be at, or already past, the trough of its business cycle. The only problem is that monetary growth has already passed the peak levels of end-1980. If the balance of payments remains in surplus the correct course for the monetary authorities to take is to revalue the Baht, a move which would be symmetric to the mid-1981 devaluation when the balance of payments was deteriorating and monetary growth falling.

With its currency fixed to the US dollar and interest rates inflexible the Thai economy is bound to be closely synchronised to that of the US. Japan, on the other hand, is able to enjoy some autonomy from the US business cycle by allowing its exchange rate to float and pursuing an independent monetary policy. The fact that the Bank of Japan has kept the growth of the money supply relatively stable means that Japan has not suffered large fluctuations in activity, the brunt of adjustment to world economic conditions having been borne by the exchange rate. Nevertheless, the Japanese economy did slow over 1981/1982 as export growth dropped sharply and the domestic economy was not able to entirely compensate for weakness in the external sector.

Japan is now past the trough of its business cycle. Year-on-year export growth is now turning positive having been -17.8% in October of last year. Consumer price inflation is under 2% and the yen is undervalued on a purchasing power parity basis, thus Japan is in a very good position to benefit from world recovery. However, the recovery in growth will be gradual as the Bank of Japan has been reducing monetary growth - from a peak of near 11% in early 1982 to 7.4% now, in line with its

perception of the long run sustainable growth rate for the economy.

The other major Asian Pacific Rim economy which allows its currency to float is Hong Kong. However, Hong Kong has no effective mechanism of monetary control with the result that money and credit growth have fluctuated sharply in response to world business cycles. Hong Kong dollar M3 growth plummeted from 40% at the end of 1980 to 2.5% now. Inflation, currently at 10.5% has remained persistently high although it should fall from here. With monetary growth low and inflation high, as well as interest rates at high levels because of political pressure on the currency, the recovery in Hong Kong may be slower to begin than in some of the other Asian Pacific Rim countries. However, Hong Kong has undergone a severe phase of cyclical adjustment (growth dropped from 10.9% in 1981 to 2.4% in 1982), the exchange rate is competitively valued, and the fundamentals are in place for a sound export-led recovery.

FORECAST: To summarise, most of the major Asian Pacific Rim economies underwent a slowdown in monetary growth over the 1980/1981 period, and thus have been through an adjustment phase which places them in a position to benefit from economic recovery in the industrialised countries. In most of the economies inflation has fallen to a greater or lesser degree, thus enabling them to enjoy a pick up in economic growth which will not be immediately aborted by tight liquidity or a deteriorating external position. The economies in which this is most obviously the case are Thailand and Singapore where inflation is at very low levels and liquidity very easy. It is also true of Malaysia, although there inflation has bottomed at higher levels due to domestic factors and thus the end of the upswing - some years hence - can more clearly be visualised. In Hong Kong the recovery may be delayed somewhat as liquidity remains tight and inflation high, but a fundamental economic adjustment has occurred and conditions are in place for a resumption of export-led growth. In Japan the recovery will be gradual and sustained as a result of the stable monetary policies pursued by the Bank of Japan. Thus, in conclusion, these five economies can all look forward to a period of high growth and buoyant economic activity, over the next few years.

The main exception is Australia, which has undergone no monetary slowdown and where inflation remains high and the current account is in large deficit. Any pick up in economic growth would require higher monetary growth which would lead to still higher inflation and quickly abort the recovery. A secondary exception is the Philippines where a slowdown in monetary growth did occur in 1980/1981 but where monetary growth and inflation are still too high, and the trade position still poor. This economy must also endure a further period of slower growth before a fully fledged recovery can begin.

A GROWING ROLE FOR LONG-TERM CAPITAL FLOWS

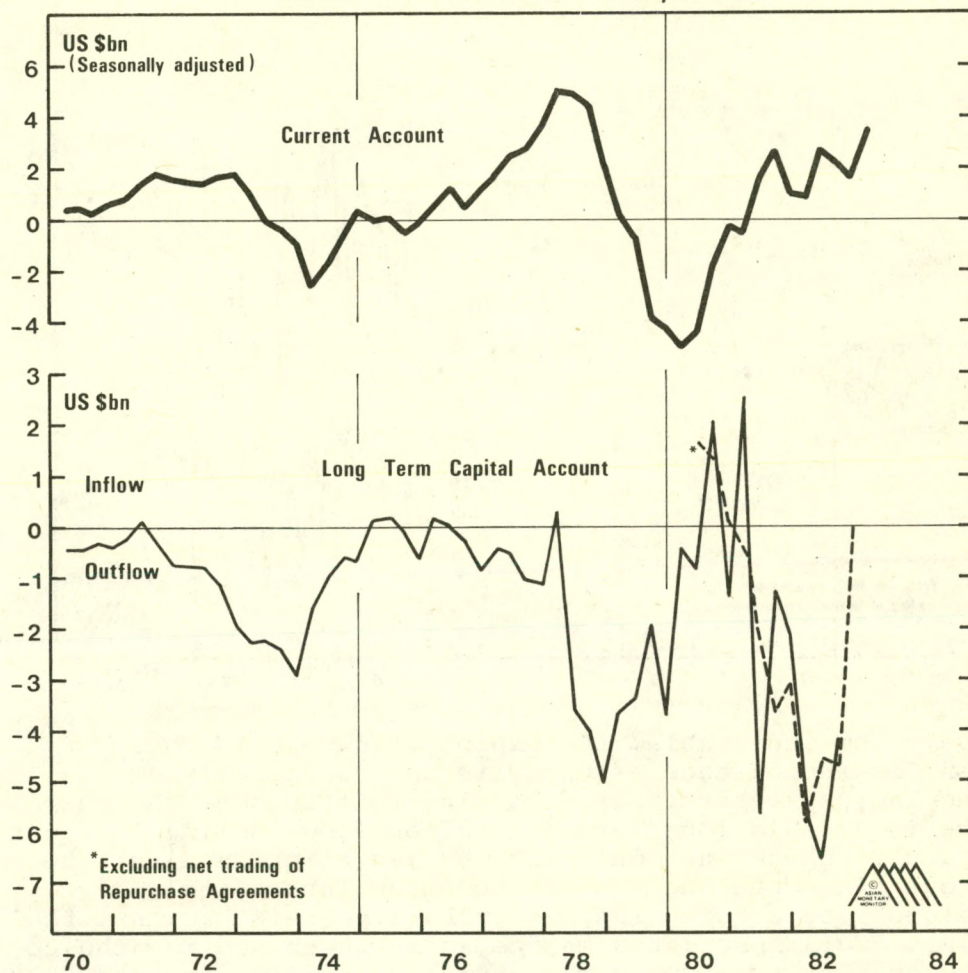
Transactions on Japan's long term capital account have risen very considerably over the past fifteen years. In 1969, long term capital outflows totaled US\$386 million and capital inflows were recorded as US\$231 million leaving a net deficit of US\$155 million. In 1982, by comparison, long term capital outflows measured US\$27,461 million and capital inflows US\$12,454 million to produce a net outflow of US\$15,007 million. Another way to record the increased importance of Japan's long term capital transactions in the overall balance of payments is to measure their growth relative to that of the trade account. In 1969, long term capital outflows represented only 2.5% of Japanese imports for the year whilst inflows measured 1.4% of total exports. However by 1982 these proportions had risen considerably: long term capital inflows had grown to 8.9% of exports whilst the ratio of long term capital outflows to imports had soared to 19.7%.

In each of the last two years large deficits on the long term capital account have more than offset Japan's current account surplus. Thus, even if one makes allowance for the unusually depressed levels of Japanese imports and exports in 1982, it is apparent that long term capital transactions have come to rival those on the trade account in determining the overall position of Japan's balance of payments. This short note describes some of the main developments on Japan's long term capital account during the past decade.

Chart 1 records the quarterly performance of the long term capital account relative to Japan's current account position. It is apparent that since 1969, Japan has only once recorded a long term capital account surplus - in 1980 when the surplus measured US\$2,394 million after a substantial deficit of US\$12,618 million in 1979. It is no coincidence that Japan registered its only long term capital account surplus in the year of a record current account deficit. Under a floating exchange rate one should expect current account surpluses to be matched by capital account deficits and vice-versa, and indeed this proposition is fairly well illustrated in the mid 1970s where the swing from a current account deficit of US\$682 million in 1975 to a surplus of US\$16,534 million in 1978 corresponded to successive increases in the long term capital account deficit from US\$272 million to US\$12,389 million over the same period.

The simplest explanation for the theoretical inverse relationship between the direction of change in the current account and the capital account is provided by a flow of funds approach. If Japan's current account surplus rises, it must be the case that domestic absorption of goods and services is less than domestic production of goods and services. If we make use of the simplifying assumption that there is no change in the government sector of the economy then a fall in domestic

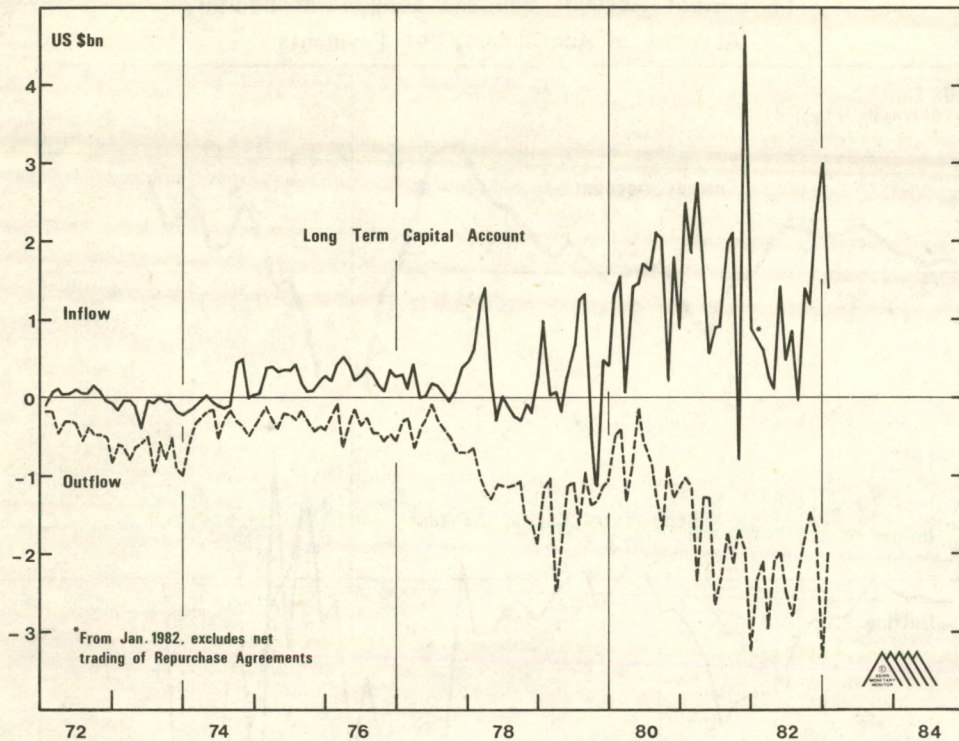
Japan: Chart 1
The Current Account and the Long Term Capital
Account of the Balance of Payments



absorption of goods and services relative to domestic output implies that savings rise relative to investment in the domestic economy. In other words the domestic private sector is acquiring assets from overseas. These assets may be in the form of foreign currency or they may be in the form of other claims on the overseas sector such as bonds and equities, or real physical assets such as houses, factories or warehouses. In either case the private sector's acquisition of foreign assets represents a capital outflow. Thus, one would typically expect a current account surplus to exist side by side with a long term capital account deficit. This has been reasonably well demonstrated in Japan since 1970.

The actual levels of long term capital outflows and inflows are recorded in Chart 2. Throughout the early 1970s and in the two years following the first oil crisis the volume of transactions on Japan's long term capital account remained

Japan: Chart 2
The Long Term Capital Account

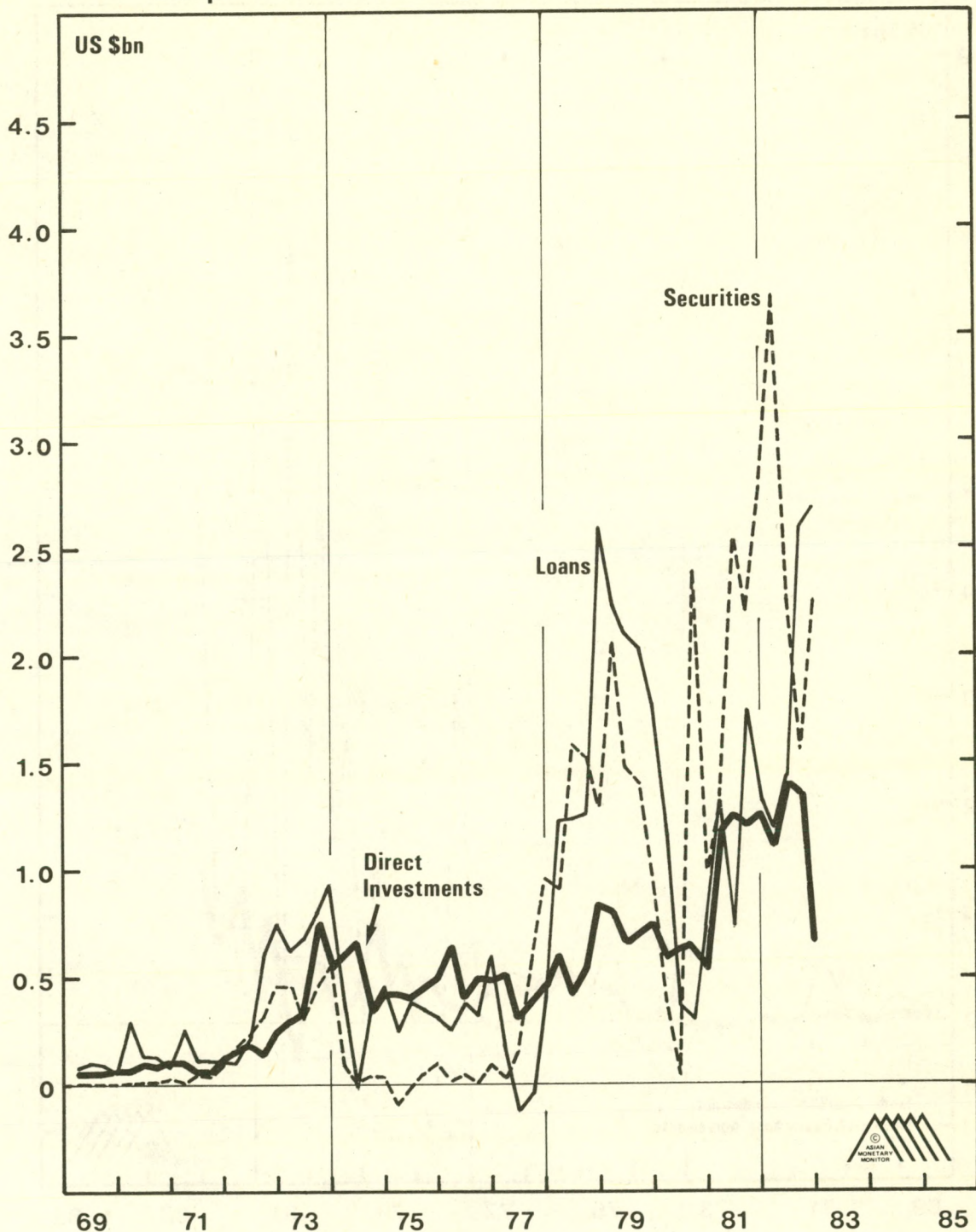


relatively low and stable: the explosive growth in this component of the balance of payments has really only arisen over the last six years. It is of interest to note the sharp increase in Japan's long term capital outflows during 1977 and 1978 - a period when not only was the yen strong against the US dollar but also when the yen was becoming increasingly "overvalued", on a Purchasing Power Parity basis, against the US dollar. For those Japanese companies which had the choice, it could only be considered rational for them to increase their acquisition of overseas assets during a period when the yen was, historically, very strong and when the US dollar appeared undervalued on the basis of relative inflation rates. This argument seems to find some confirmation in the curtailment of capital outflows from Japan in line with the yen's general weakness during 1979 and the first quarter of 1980, and in the light of the recovery in long term capital outflows as the yen strengthened to Yen200 at the end of 1980.

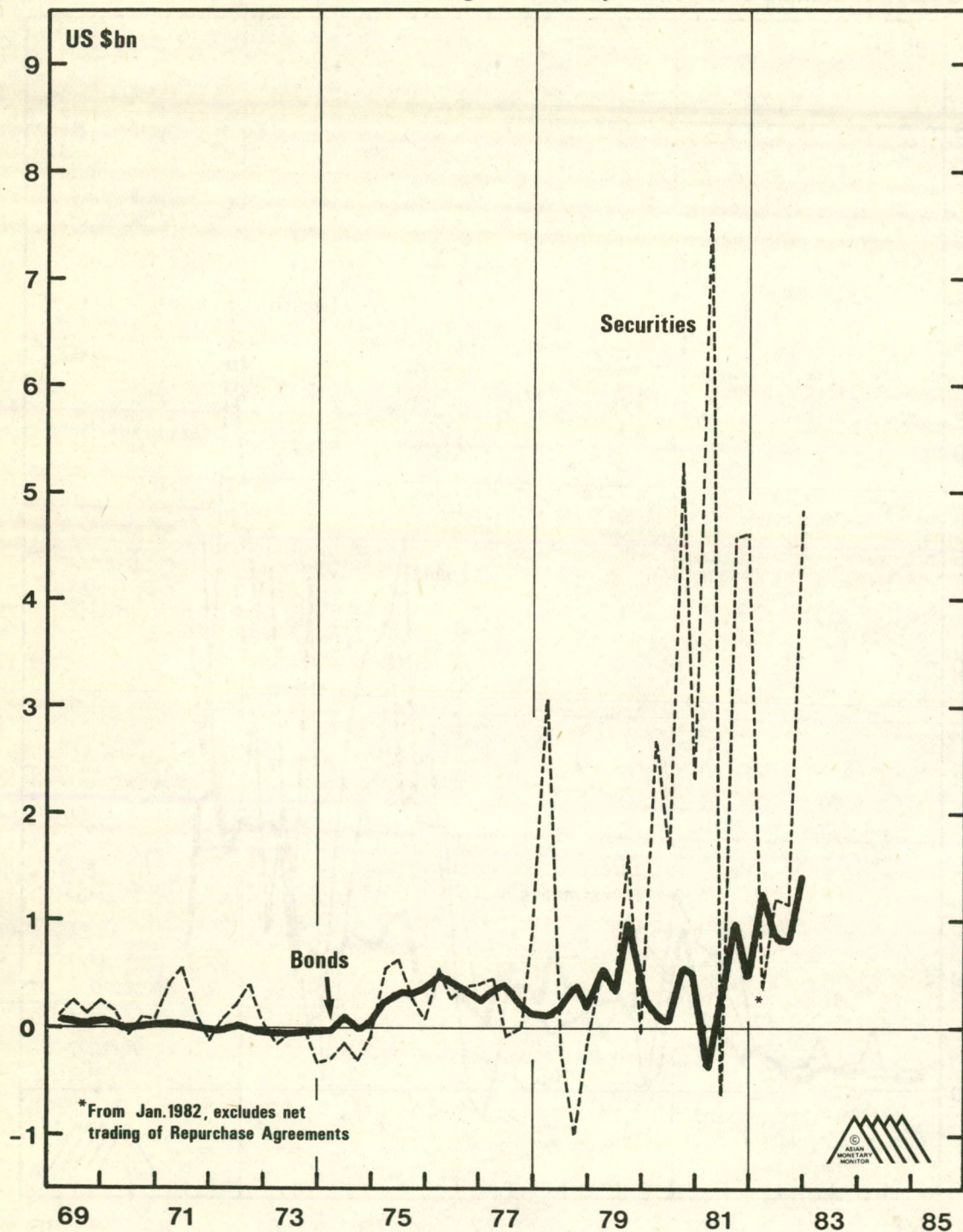
However, long term capital outflows continued to rise throughout 1981 and into 1982 in spite of the yen's persistent depreciation and a widely held view that the Japanese currency was undervalued. This may well have been partly connected to the implementation, in December 1980, of the new Foreign Exchange and Trade Control Law which made it possible for Japanese institutions to invest or lend abroad without requiring prior approval from the Ministry of Finance. Chart 3, which breaks down the long term capital outflow into its main components, highlights the fact that the principal increment to capital outflows during 1981

Japan: Chart 3

Components of the Long Term Capital Outflow Account



Japan: Chart 4
Components of the Long Term Capital Inflow Account



came from Japanese investment in overseas securities markets. In spite of the weakness of the yen it seems that the presence of historically high yields - in both nominal and real terms - in foreign capital markets was sufficient to induce large scale purchases of overseas financial assets.

However the very large rise in net long term capital outflows from Japan in 1982 was not purely due to heavy Japanese investment in overseas markets but was as much the consequence of a sharp reduction in foreign investment in Japan. Long term capital inflows fell from US\$16,360 million in 1981 to US\$12,454 million in 1982. There are only two important components (see Chart 4) of Japan's long term capital inflow account - foreign purchases of domestic securities and "bonds issued in foreign currency", which refers to the raising of funds in overseas financial markets by Japanese companies. Direct investment in Japan from abroad accounts for a negligible proportion of capital inflows into Japan. In 1982 this item accounted for only 3.5% of long term inflows, up from 1.2% in 1981. The decline in long term capital inflows into Japan in 1982 was more than accounted for by a reduction in foreign purchases of Japanese securities from US\$15,075 million in 1981 to US\$7,553 million. This reduction was partly offset by a rise in Japanese company borrowing in foreign capital markets from US\$1,368 million to US\$4,311 million.

In recent years, overseas purchases of Japanese bonds and equities appear to have been heavily influenced by the expectations of a strengthening yen. Thus foreign purchases of Japanese securities peaked in the first quarter of 1981, which also proved to be the recent cyclical high of the yen against the US dollar. Similarly, overseas interest in Japan's capital markets rose strongly in the final quarter of 1981 when the yen appreciated strongly against all major currencies and the consensus expectation amongst most foreign exchange market analysts was that the Japanese currency would appreciate further during 1982. However, probably the most interesting feature of the recent history of overseas investment in Japanese securities occurred in the final two months of 1982. A comparison of Charts 1, 2 and 4 indicates that it was a substantial rise in foreign purchases in Japan's capital market which was solely responsible for eliminating Japan's net long term capital account deficit in that period. In this respect one may suggest that overseas investors' perception that the yen was fundamentally undervalued proved self-fulfilling, as the yen rose from Yen277 to Yen235 against the US dollar during the final two months of 1982.

FORECAST: Currently the market perception is that the yen is undervalued against the US dollar and will rise over the course of the year. This may add some stimulus to capital inflows into Japan. However, the primary influence on the Japanese capital account is likely to be the rising trend on the current account of the balance of payments. Year-on-year export growth is beginning to turn positive and is likely to improve markedly as the world economy recovers. When taken

together with the reduction in oil prices and the likelihood that commodity prices will not recover until later in the world business cycle, this suggests a substantial improvement in Japan's current account surplus. This implies that the domestic private sector will probably once again acquire financial assets overseas on a significant scale. Therefore one should be prepared for a growing deficit on Japan's long term capital account over the coming year.

SOUTH KOREA

A RETURN TO MONETARY RECTITUDE ?

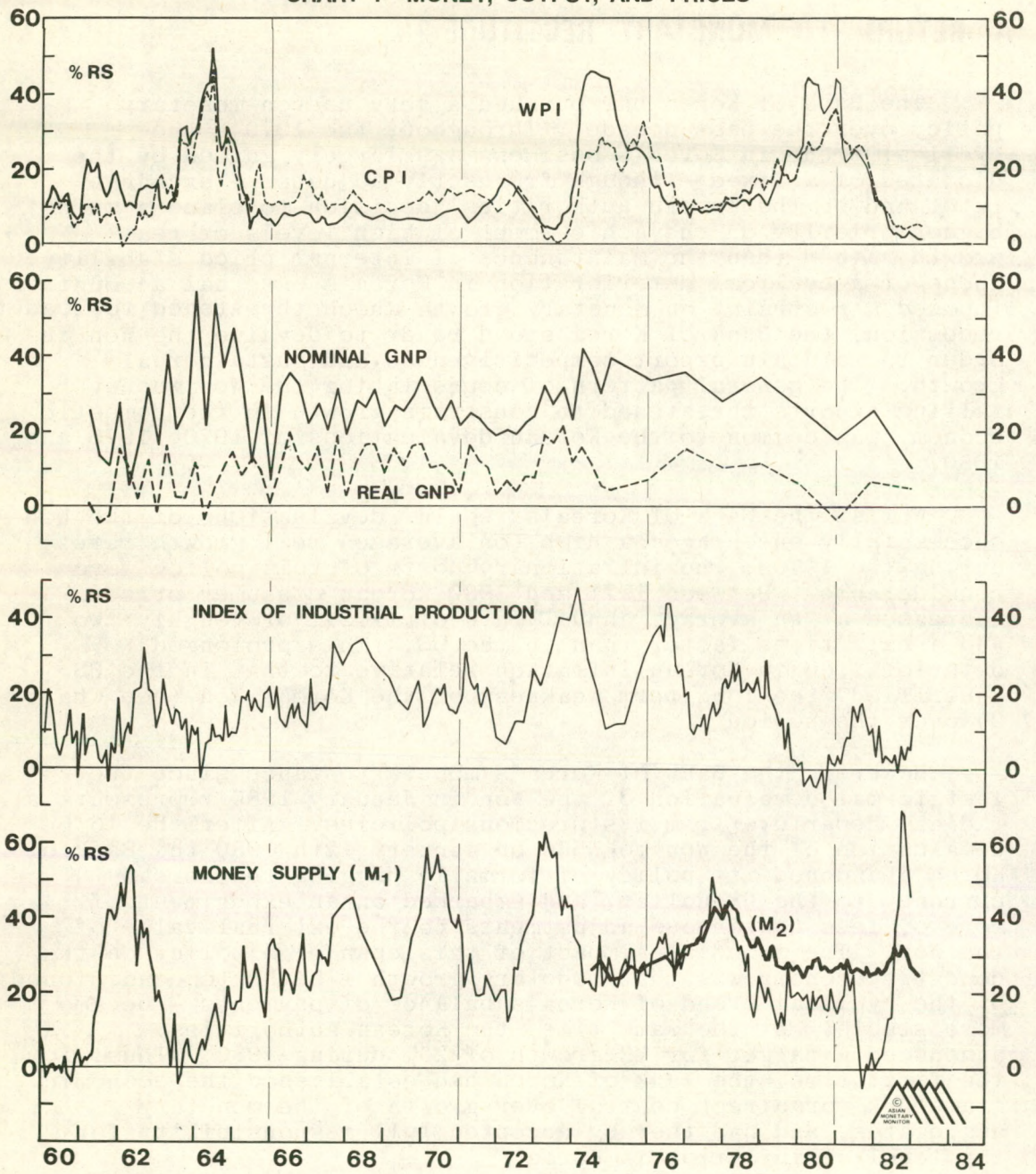
The Bank of Korea has pursued a very uneven monetary policy over the past decade. Throughout the 1970's the cyclical trend in Korea's business was largely guided by the dictates of a fixed - though frequently adjusted - exchange rate, and by the Korean authorities' decision to place a much higher priority on the achievement of high levels of real growth rather than the maintenance of internal price stability. Whenever a cyclical deterioration in Korea's external account imposed a restraint on monetary growth which threatened to lead to recession, the Bank of Korea stood ready to devalue the Won in order to maintain export competitiveness and sustain real growth. The general pattern of depreciating the Won whenever falling exports threatened to constrain growth in the domestic economy was common to the Korean devaluations of 1970, 1975 and 1980.

Whilst the Bank of Korea's regular devaluations of the Won successfully encouraged a high (on average) real growth rate during the 1970s, the inflationary costs of this policy were considerable. Between 1971 and 1980 Korean consumer prices increased at an average annual rate of 17.2%, or roughly two and a half times faster than in the US. This prolonged deterioration in Korean inflation relative to that in the US "justified" the long term weakness of the Korean Won (see Chart 2) over the period.

However, the Bank of Korea's monetary stance since the last formal devaluation of the Won in January 1980 represents a radical departure from its previous policies. After the 16.6% devaluation of the Won to W580 on January 12th 1980 the Bank of Korea abandoned its policy of formally pegging the Korean currency to the US dollar, and embarked on an experiment of more or less continuous adjustments to the external value of the Won. The immediate impact of this change in policy on the domestic economy was that monetary growth - hitherto conditioned by the cyclical trend of Korea's balance of payments - became more stable. At the same time, the Korean authorities announced a target for M2 growth of 20% during 1980. Thus, for the first time, the Bank of Korea had established the economic framework for direct control over growth of the monetary aggregates, and had thereby accepted full responsibility for the level of inflation in Korea.

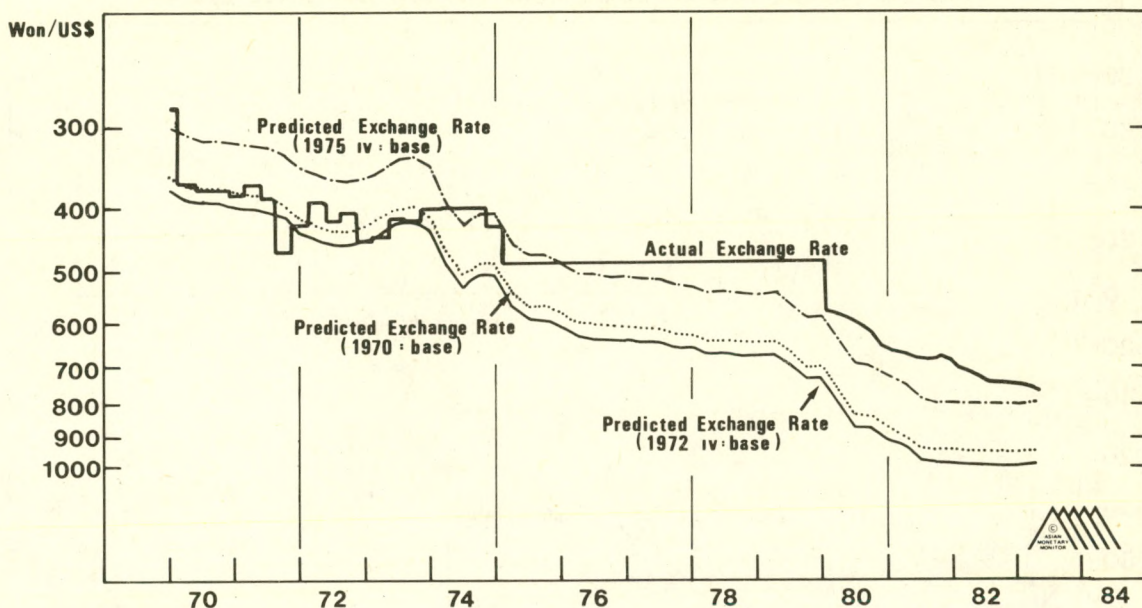
At the start of 1980, the Bank of Korea showed every indication of being determined to fulfil its monetary objectives. Immediately after the formal devaluation of the Won, the Central Bank raised its discount rate from 14.5% to 20.5%, forcing a five percentage point rise in commercial bank overdraft rates to 26%. The ensuing monetary squeeze was particularly severe. The annualised growth in M2 plummeted from around 37% in the second half of 1979 to roughly 16% in the first six months of 1980. Further testimony to the

SOUTH KOREA
CHART 1: MONEY, OUTPUT, AND PRICES



SOUTH KOREA

CHART 2 : ACTUAL AND PREDICTED EXCHANGE RATES



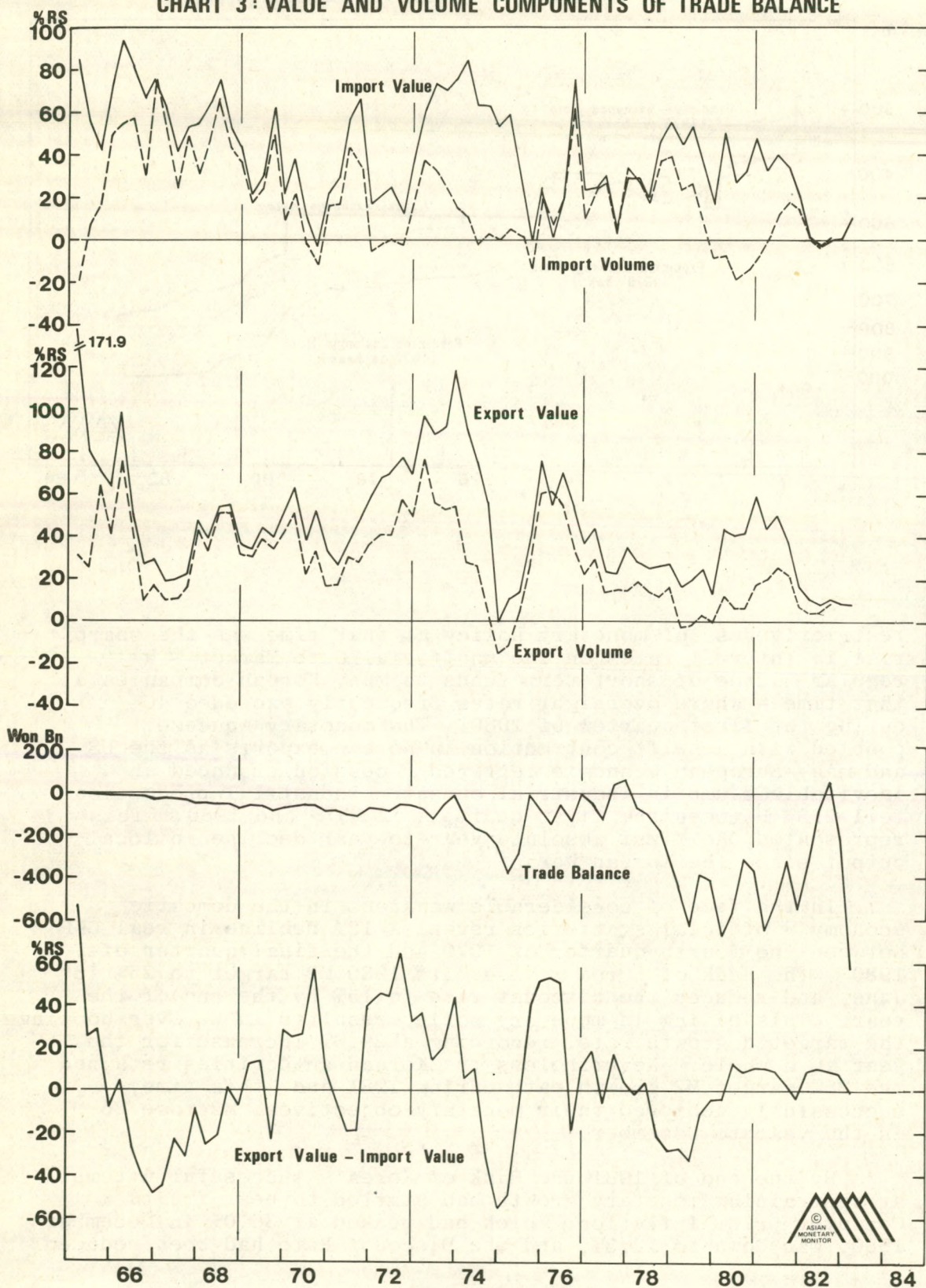
restrictiveness of monetary policy at that time was the sharp rise in interest rates on the unofficial Curb Market - a regular source of short term funds to many Korean companies at that time - where overnight rates frequently exceeded 40% during the first quarter of 1980. The monetary squeeze, coupled with a swift contraction in Korean exports as the US and many European economies entered recession, produced an inevitable slump in industrial output. Industrial production fell 2.8% between the first quarters of 1979 and 1980. This represented the first absolute year-to-year decline in local output since the Korean War.

In the face of considerable weakness in the domestic economy - official statistics reveal a 12% decline in real GNP between the fourth quarter of 1979 and the final quarter of 1980 - the Bank of Korea revised its 1980 M2 target to 25% in June, and reduced the discount rate to 15% by the end of the year. This easing in monetary policy resulted in M2 overshooting the targeted growth rate, recording a 29.6% increase for the year as a whole. Nevertheless the Korean authorities retained the 25% target M2 growth path during 1981 and, this time, successfully achieved their monetary objectives: M2 rose 25.9% in the year to December.

By the end of 1981 the Bank of Korea's successful attempt at restraining monetary growth had started to bear fruit. Consumer price inflation, which had peaked at 36.0% in December 1980, was down to 12.3%, and the Discount Rate had been reduced

SOUTH KOREA

CHART 3: VALUE AND VOLUME COMPONENTS OF TRADE BALANCE



to 12½%. The combination of relatively stable monetary growth, falling inflation, and declining interest rates generated easier domestic liquidity conditions. Korean exports, encouraged by a transient recovery in the US economy rose strongly in the first half of 1981 and by June had increased 30.9% from the previous year (see Chart 3). The improved export performance was also reflected in a recovery in industrial production (up 17.3% in the year to September 1981) and a booming stock market - where share prices rose an average of nearly 50% during the first half of that year.

Nevertheless, as turned out to be the case in both Japan and Taiwan, the recovery in the Korean economy proved vulnerable to further recession in the US. The sharp contraction in the level of economic activity in the US at the end of 1981 swiftly curtailed Korean export growth. By December 1981 export growth was running at about 10%, or only one third of the level of the second quarter of that year. Industrial production also faltered and by March 1982 had risen only a meagre 1.6% from the previous year.

In January 1982 the Bank of Korea reaffirmed its commitment to a "hard money" policy by announcing that the M2 growth target for 1982 had been reduced to 20%-22% from 25% in 1981. However, confidence in the Korean authorities' resolve in achieving this objective was immediately undermined when the Bank of Korea slashed the discount rate from 10.5% to 6.5% on January 14th 1982! The Bank of Korea's accommodative monetary policy continued throughout the first nine months of 1982. The discount rate was again reduced, to 5.0%, in March of that year and in August the Ministry of Finance suggested that M2 growth could average 30%-32% for the year as a whole. In our last article on the Korean economy (AMM Vol. 6 No. 4) it was suggested that the advent of the Curb Market Crisis in May 1982, which brought about the bankruptcy of three publicly quoted companies and a 10% decline in stock prices within a matter of days, was an important element behind the Bank of Korea's decision to accommodate rapid growth in the monetary aggregates.

When the Bank of Korea moved to enforce direct control over the money supply in January 1980 it had also, in order to implement its policy, encouraged greater interest rate flexibility and had reduced the level of "directed lending" by the commercial banks to Korean manufacturing and trading companies. This liberalisation of capital markets was wholly in accord with the monetarist, free market approach to domestic economic management but it must have left many highly leveraged Korean companies in an exposed position. The risks involved where companies substantially leverage their equity base are much greater in an environment where they must bid competitively for commercial bank credit than in an environment where credit is "allocated". As an illustration of this vulnerability the first company to be bankrupted when confidence in the Curb Market collapsed was Ilssin Steel Co. which at the end of 1981 had a debt-equity ratio of 1,137%.

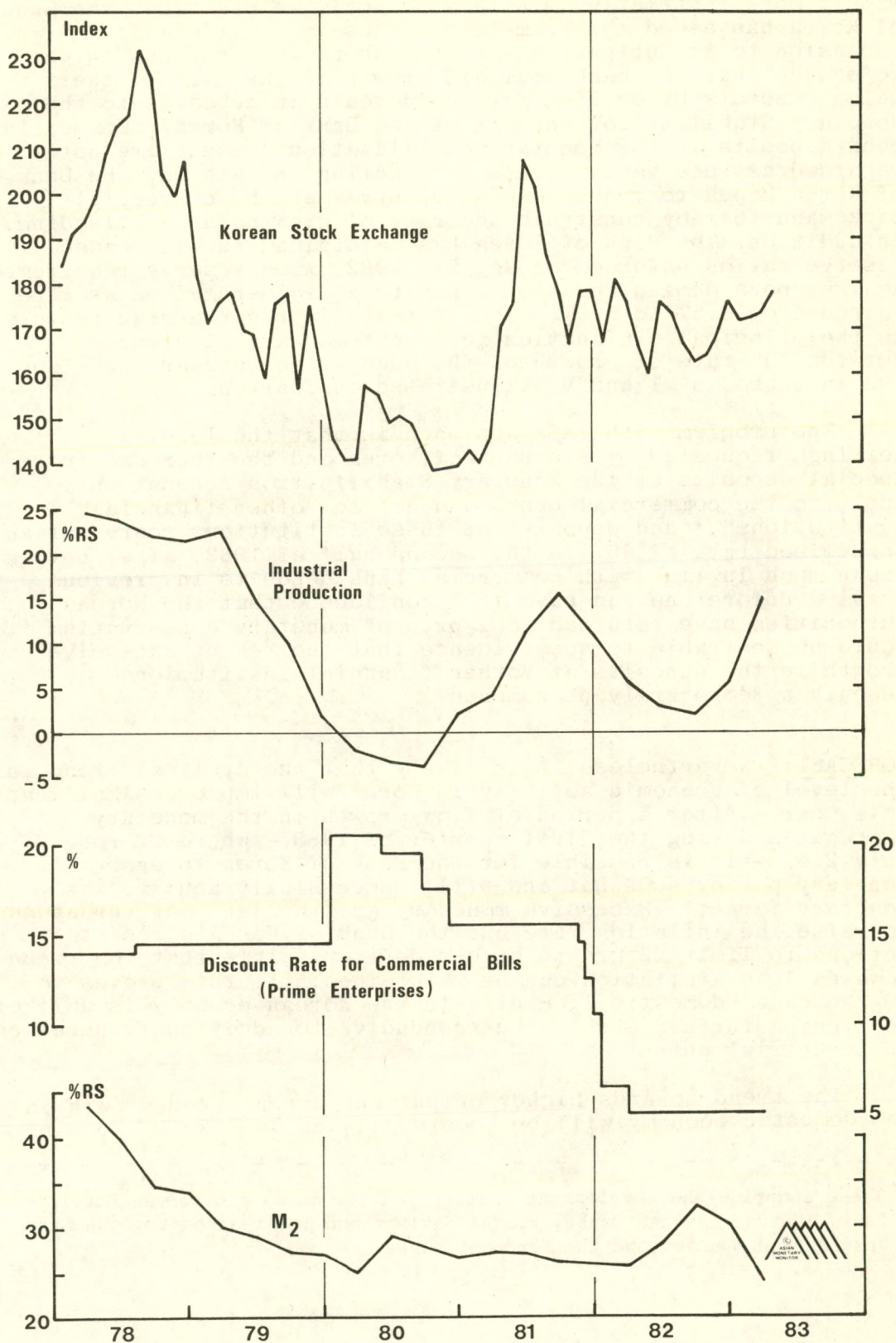
As so often occurs in other countries, the credit crisis of May 1982 and the associated easing of monetary policy signalled the approach of the trough in Korea's business cycle. Industrial production fell 1% in the year to August 1982, but has since risen strongly - increasing 16.0% in the year to February 1983. Typically one would have expected a recovery in output of this order to be accompanied by the start of a bull market in local equities particularly when, as now, other capital markets are booming. However prices on the Korean stock exchange (see Chart 4) have yet to move convincingly above the relatively lowly levels of last year.

The most probable explanation of this somewhat surprising combination of developments is that the Bank of Korea appears to have again reversed its basic monetary policy. After rising 32.8% in the year to September 1982, M2 growth decelerated to 23.7% in March. In December 1982 the authorities announced their intention to gradually reduce M2 growth to 18% by the fourth quarter of 1983 and established an interim target of 26%-27% annualised growth in that aggregate for the first three months of this year. On March 24th, however, the Bank of Korea issued a revised target: in the wake of sluggish growth in M2 during the first two months of the year it is now intended to limit M2 growth to 15%-16% for the whole of 1983.

There can be little doubt concerning the reasons behind the Bank of Korea decision to restrict monetary growth. M2 growth rates in excess of 30% were patently inconsistent with the maintenance of the impressively low levels of inflation recorded at the end of 1982. (Consumer prices increased by a modest 4.8% in the year to December, and by 4.7% in the same period to March 1983.) The considerable easing in domestic liquidity during the second half of last year has already been reflected in strong growth in industrial output, and the semblance of a boom in the local property market. This must have been of concern to the Korean authorities, since little of the 16% rise in industrial production during the past year reflects rising export demand. So far, in spite of both a 3.0% depreciation of the Korean Won against the US dollar during the past six months and growing evidence of a recovery in the US and European economies there has been little indication of any significant upturn in overseas demand for Korean goods and total exports rose only 4.2% in the year to March. Korean imports, on the other hand, have recovered quite strongly from the cyclical trough in the third quarter of 1982. At that time imports had declined nearly 12% (in US dollar terms) from the previous year compared with a 5.6% increase (in line with the recent rise in industrial production) in the year to March. Thus Korea's current account deficit for the first quarter of this year widened to US\$954.5 million from US\$341.7 million in the corresponding period in 1982.

Whilst the Bank of Korea's efforts to reduce excessive monetary growth are laudable there is, unfortunately, a question-mark against the overall effectiveness of its current policy. The Korean authorities intend to halve the rate of M2 growth to 15% over the course of 1983 but, so far, there has

S. Korea : Chart 4
Liquidity Indicators, Production and the Stockmarket



been no indication that this will be brought about by higher domestic interest rates - which would typically be associated with a more restrictive monetary policy. In practice, the Bank of Korea has asked the commercial banks to limit credit expansion to the private sector to "about 10%" and has sought to ensure that the banks curtail growth in the size of their balance sheets by calling for an increase in deposits to the Monetary Stabilisation Account at the Bank of Korea. Commercial bank deposits in the Monetary Stabilisation Account are not regarded as reservable assets. By acting in this way the Bank of Korea hopes to reduce excess reserves at the commercial banks and thereby constrain the rate of growth in bank lending. In addition, the Bank of Korea has maintained the increased reserve ratios enforced on May 5th 1982, when reserve requirements against both demand and time deposits at commercial banks were raised from 3.5% to 5.5%. The increase in reserve requirements is the principal explanation for the temporary divergence between the rate of growth of the unadjusted monetary base and the increase in M1 and M2 illustrated in Chart 5.

The problem with this approach is that the lending ceilings requested by the Bank of Korea and the increase in special deposits at the Monetary Stabilisation Account only apply to the commercial banks and not to "other financial institutions",* and deposits at these institutions soared at an annualised rate of 45% in the second half of 1982, after having grown much in line with commercial bank deposits in previous years. Before one can have full confidence that the Korean authorities have returned to a path of monetary conservatism it would be desirable to see evidence that the recent excessive growth in the deposits at "other financial institutions" is only a temporarily phenomenon.

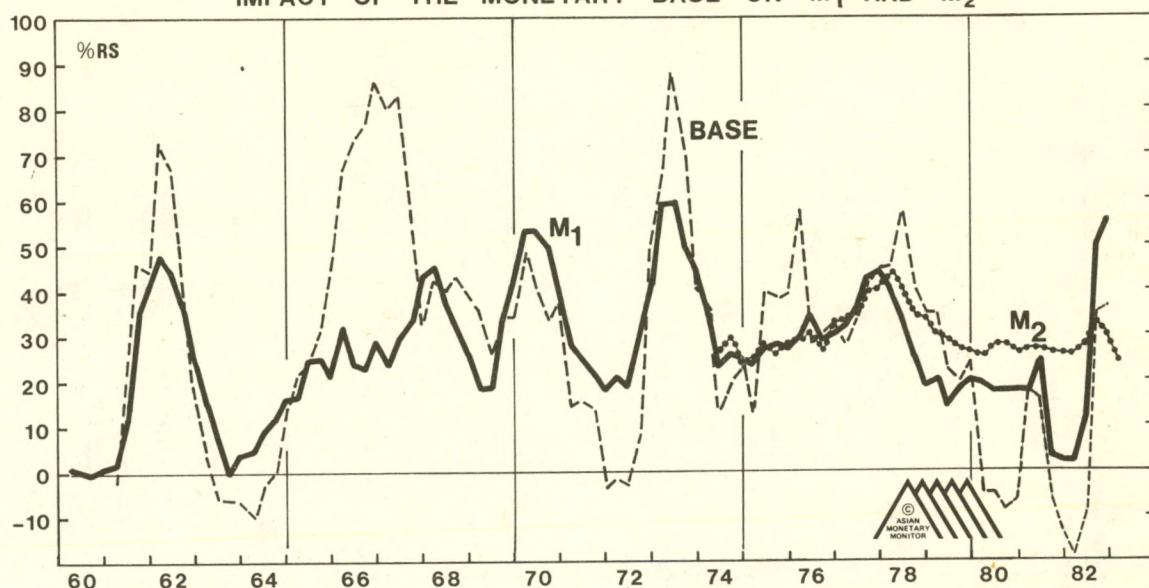
FORECAST: Nevertheless it is likely that the cyclical trend in the level of economic activity in Korea will improve significantly this year. After a period of slow growth in the monetary aggregates during the first quarter of 1983 - where M2 rose only 2.4% - it is possible for the Bank of Korea to ease monetary policy somewhat and still successfully achieve its monetary target. Excessive monetary growth last year threatened to raise the inflation rate but the Bank of Korea's recent actions to limit M2 growth have made it possible that the trend towards lower inflation can be maintained. If this proves to be the case, domestic liquidity in the Korean economy is unlikely to tighten further and is thus conducive to additional increases in industrial output.

The trend towards higher output and a continued growth in the domestic economy will be boosted if, as is likely, Korean

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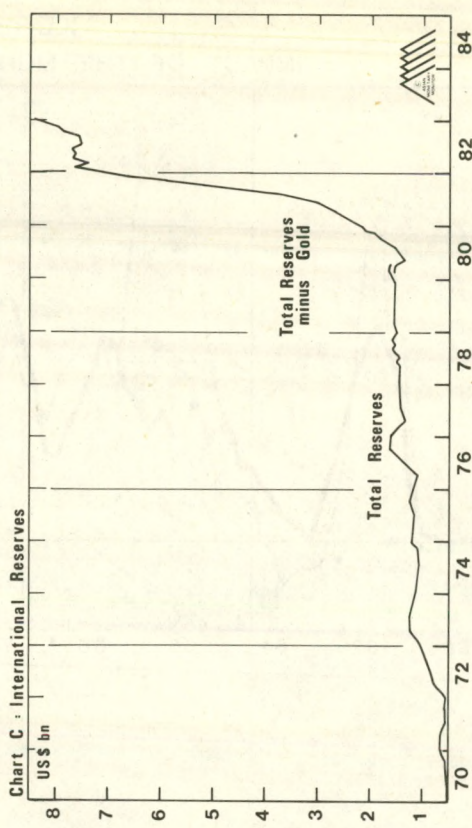
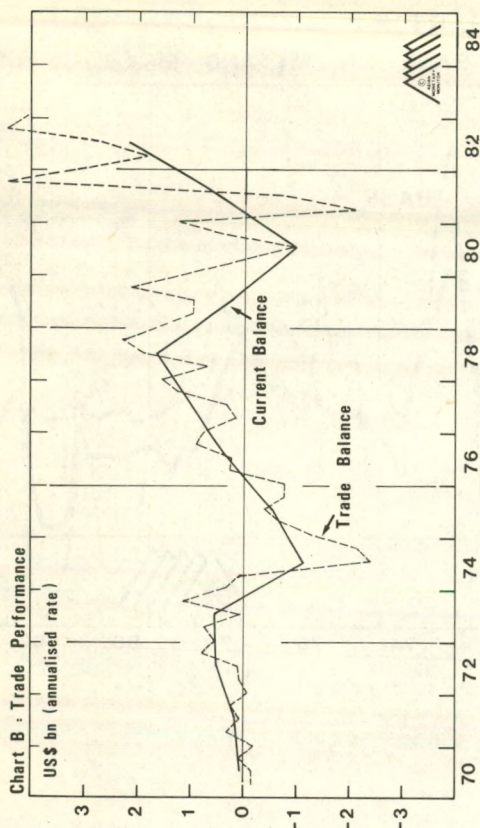
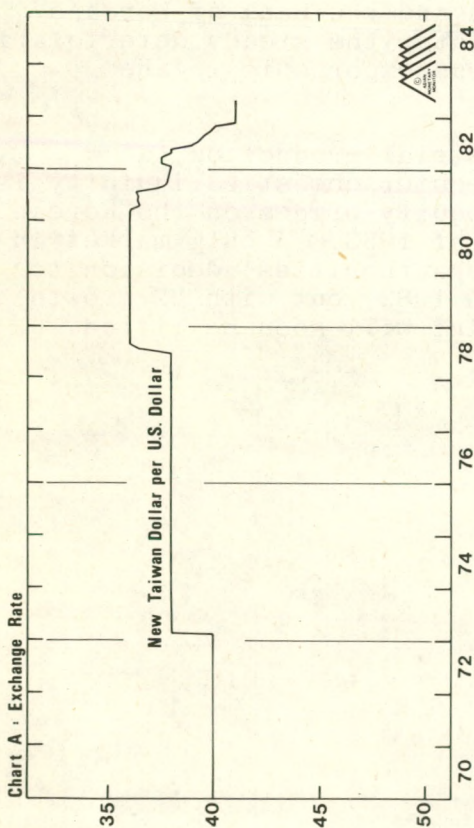
* These comprise the development institutions (such as the Korean Development Bank), Mutual Savings Banks, Postal Savings and Trust accounts, the Life Insurance companies and the Merchant banks.

KOREA : CHART 5
IMPACT OF THE MONETARY BASE ON M_1 AND M_2



exports improve in line with the recovery overseas: as a result of continued low levels of inflation and the Bank of Korea's decision to allow the Won to depreciate, the steady deterioration in the price competitiveness of Korean exports is in the process of being reversed.

The combination of higher industrial production, a recovery in exports and moderately easier domestic liquidity is likely to provide firm support for equity prices on the Korean stock exchange during the remainder of 1983. A bull market in Korean equities was postponed by the authorities' decision to correct the monetary excesses of mid 1982, but with M2 growth now well within target this constraint will soon be lifted.



The New Taiwan Dollar should be regarded as a cyclically strong currency. It is very unlikely that the N.T. dollar will be devalued from its existing level of around N.T.40.0 = US\$1 and one can already see pressure emerging for a revaluation of Taiwan's currency over the next year or two.

Taiwan's economy is emerging from a particularly protracted slowdown that has lasted since the start of 1979: real economic growth has declined in each of the last four years and measured a comparatively meagre 3.8% in 1982, or considerably below the annual average real growth rate of 10.3% during the prior five years, the fundamental reason for the decline in real growth being with the Taiwanese authorities' decision to defend the NT\$36 parity with the US dollar until August 1981. Chart D suggests that at this exchange rate the N.T. dollar was considerably overvalued. The consequence of maintaining an overvalued exchange rate at a time when the US authorities were persevering with a restrictive monetary policy was a sharp deterioration in Taiwan's trade account (Chart B) and an especially severe monetary contraction (Chart E) which led to the recession in the domestic economy.

In August 1981 the Taiwanese authorities devalued the N.T. dollar and commenced a more accommodative monetary policy. This reversal in policy had little immediate impact as Taiwanese exports slumped in the face of deepening recession overseas. Nevertheless the squeeze on the domestic economy had been so severe that the trade account improved significantly as import growth declined even more rapidly than export growth.

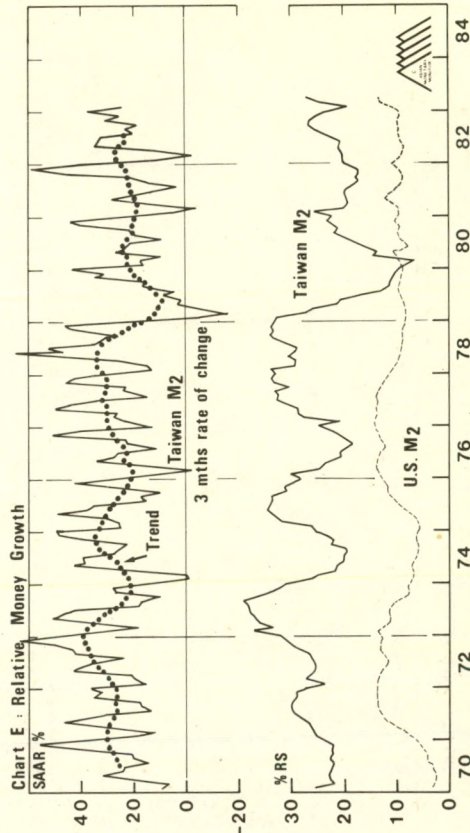
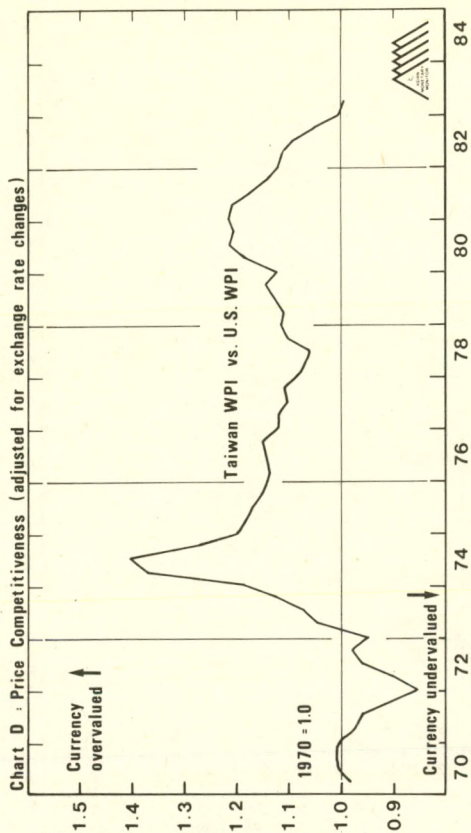
Now, however, as the OECD economies begin to recover, Taiwan is exceptionally well placed. Domestic inflation is down to 2% and exports are likely to improve swiftly with the recovery overseas, leading to an even larger trade surplus. The question then becomes whether the Taiwanese authorities will revalue in an attempt to curtail inflationary pressures. The lesson from previous cycles (1973 and 1978: see Chart A) is that there is a strong possibility of a revaluation once the domestic economy recovers.

ACTUAL FORECAST

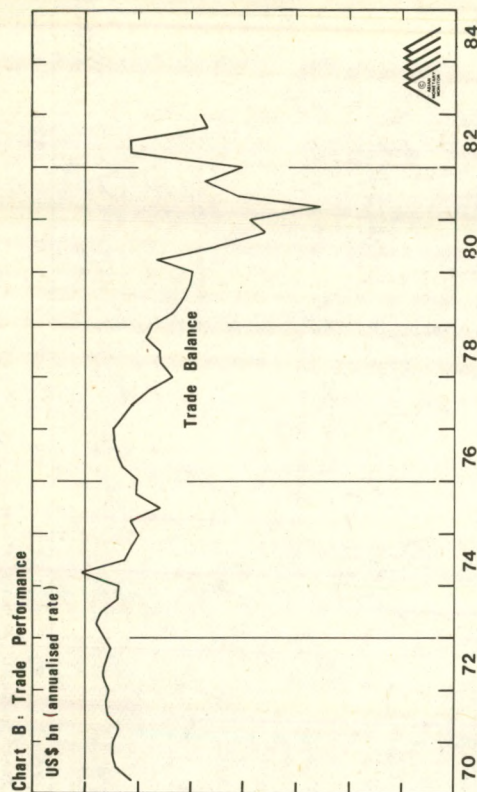
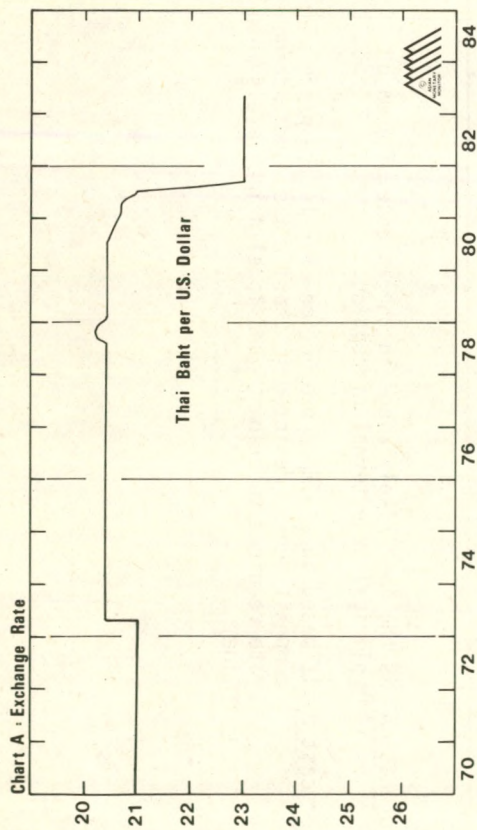
NT\$/US\$	1982	1983 Jan.-Apr.	Jun.-Sep.	Q4
FORECAST A			39-41	38-40
Actual Range	39.57-41.00	39.89-41.00	40.8	40.8
FORECAST B				

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a simple projection of relative price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels into line.



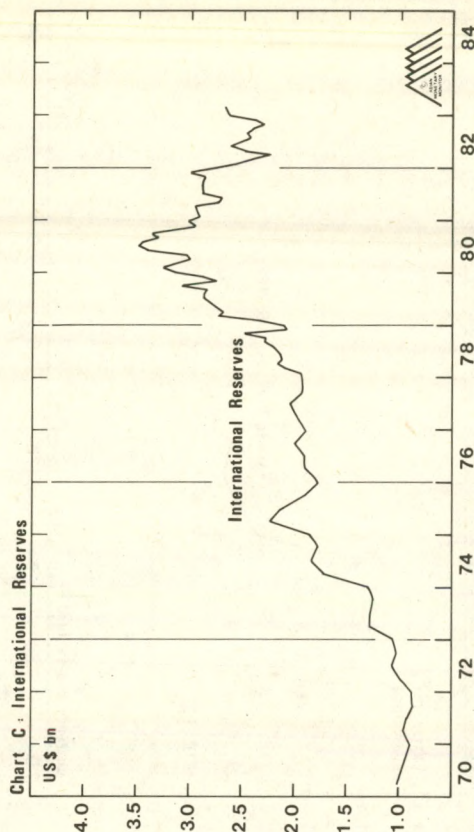
SAAR : SEASONALLY ADJUSTED AT ANNUAL RATE
RS : RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



The Thai Baht remains a fundamentally strong currency. Inflation in Thailand is now down to 2.2% year-on-year representing one of the lowest rates in the Asian Pacific Rim. The result of the sharp fall in inflation since mid-1980 is that the Baht is now very close to its purchasing power parity level against the US dollar (Chart D).

The trade account improved markedly in 1982 (Chart B), the deficit for the year having been reduced from US\$2.9 bn in 1981 to US\$1.6 bn in 1982. The improvement resulted from a decline in imports due to tight liquidity in 1981 and early 1982, destocking, and the development of domestic energy sources, and a strong export performance arising from a bumper rice crop, as well as the favourable effects of the mid-1981 devaluation. As a result of the fall in overseas interest rates, which was not matched in Thailand, capital inflows were very strong in the latter part of the year and the overall balance of payments ended the year in surplus.

The shift into surplus on the overall balance of payments resulted in a rapid pick up in monetary growth over the course of last year (Chart E). Monetary growth, when measured by either M1 or M2, has now risen to the peak levels reached at the end of 1980. Thus, with inflation very low and monetary growth very high liquidity



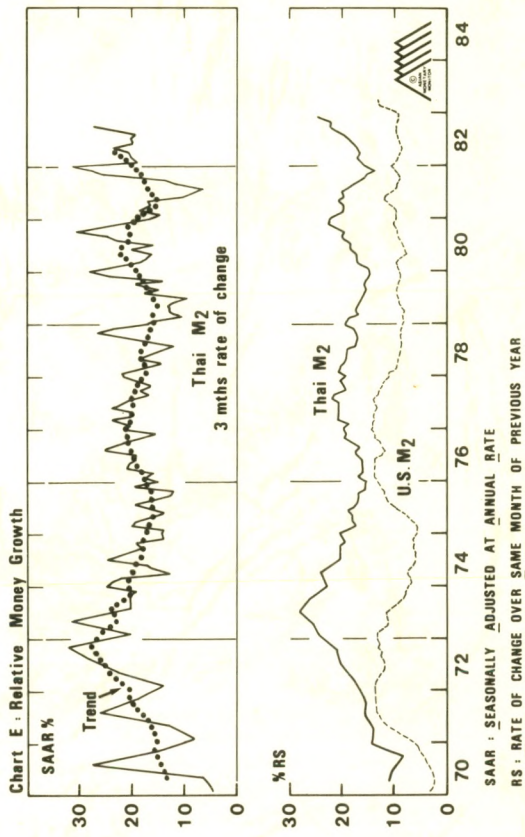
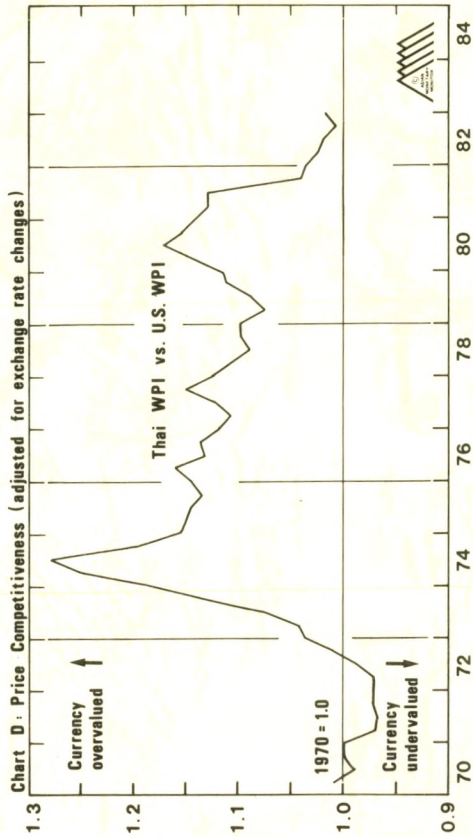
in the economy is very easy and this provides an ideal environment for a rapid recovery.

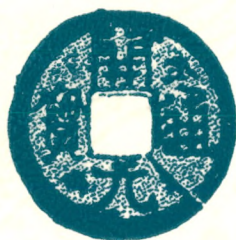
However, monetary growth in Thailand should not be allowed to rise any further. Despite commercial bank unwillingness to lower interest rates, they have now been reduced and with the stabilisation in overseas rates this should help reduce capital inflows. If, on the other hand, capital inflows continue rising then a revaluation would be necessary. Although one can see the pressures towards revaluation already building, such a move is unlikely at this stage. Export growth fell sharply in the last months of last year as export volumes dropped as a result of a poorer rice crop. Until such a time as the price of rice and other agricultural commodities begin to rise on world markets and strength in the economy becomes more evident then the exchange rate is likely to be maintained at current levels.

Baht/US\$	ACTUAL			FORECAST	
	1982	Q4	1983 Jan.-Apr.	Jun.-Sept.	Q4
				23.0	23.0
FORECAST A					
Actual Range	23.0		23.0		
FORECAST B				23.4	23.4

Forecast A The most likely exchange rate in the absence of some major political or external disruption.

Forecast B based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

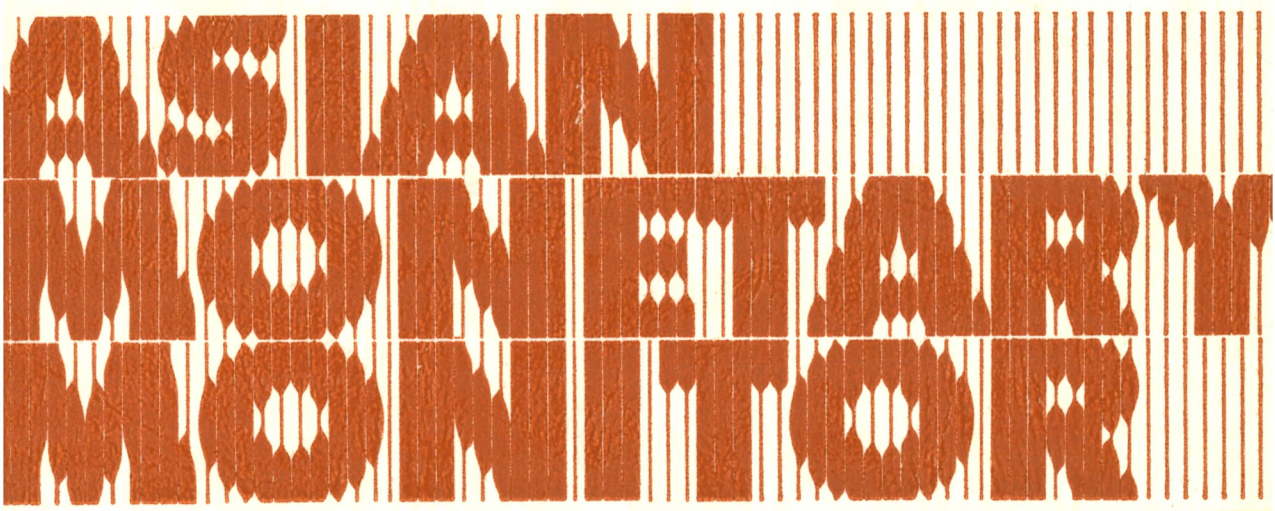




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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

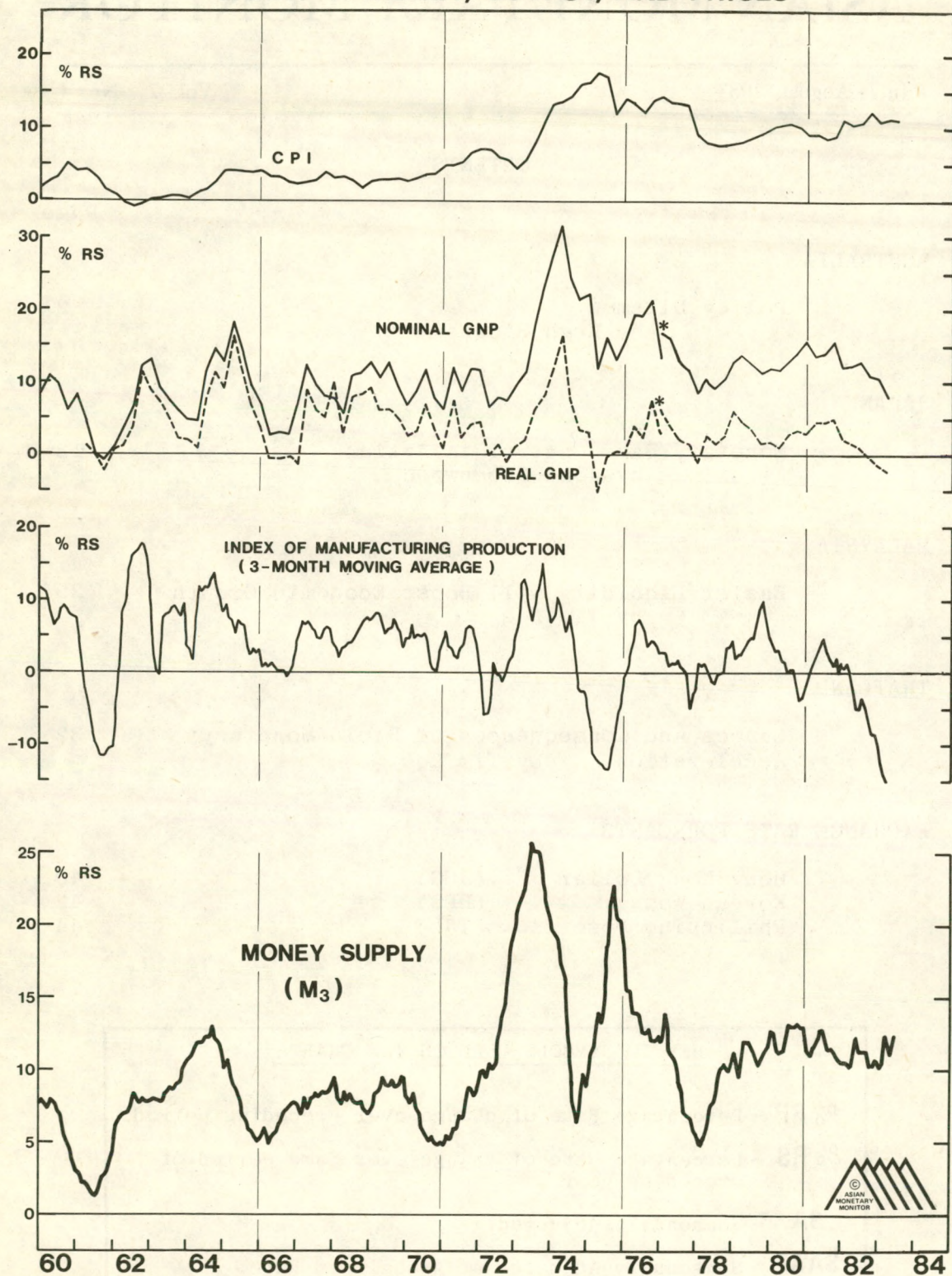
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

CHART 1: MONEY, OUTPUT, AND PRICES



*Change of data series.

AUSTRALIA

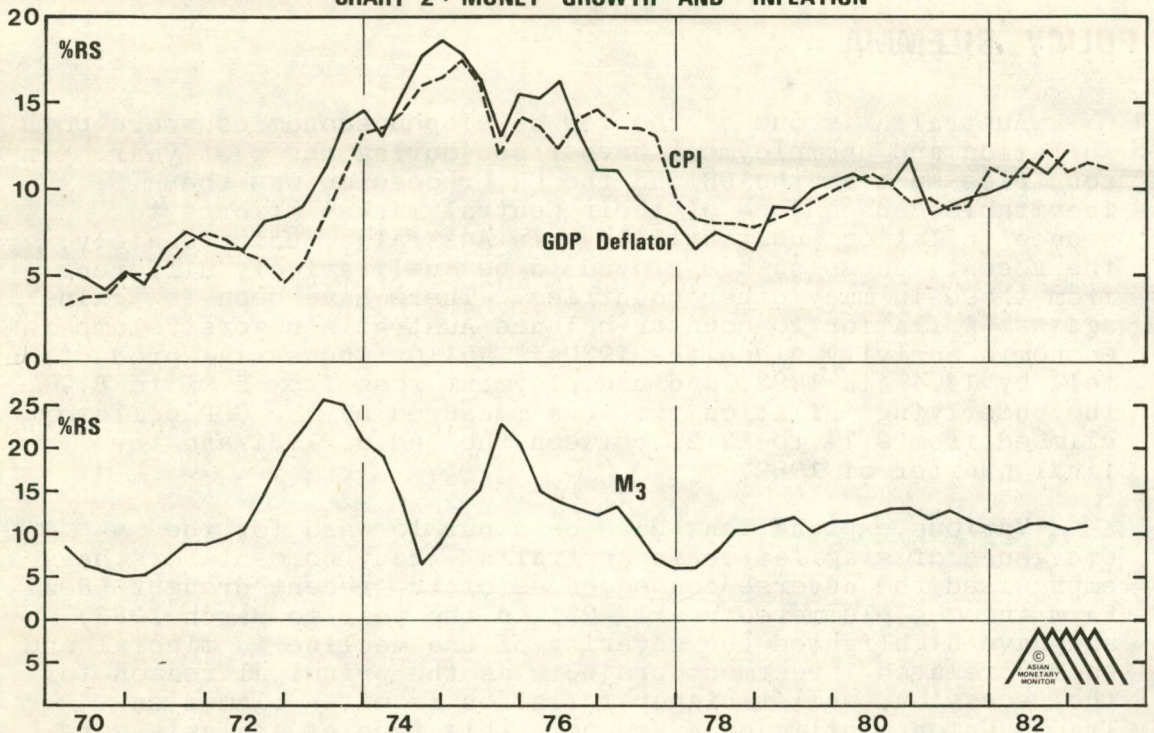
POLICY DILEMMA

Australia is one of the few developed economies where both inflation and unemployment have risen during the past year. In countries such as the US and the UK, recession was the inevitable consequence of their Central Banks' efforts to reduce inflation substantially. In Australia, unfortunately, the recent recession has proved to be qualitatively different from those in many other countries. There have been few gains against inflation to counter-balance Australia's worst slump in economic activity since the 1930s. Whilst industrial production fell by 14.4% in 1982, and unemployment rose from 5.9% to 8.7%, the underlying inflation rate (as measured by the GDP deflator) climbed from 9.7% to 12.2% between the end of 1981 and the final quarter of 1982.

Various explanations have been put forward for the emergence of stagflation in Australia. Many commentators have emphasised the adverse consequences of the recent drought (Real Farm incomes plummeted nearly 23% in the year to March 1983) and have highlighted the severity of the decline in mineral and energy related investment projects as the principal reason for the recession, whilst higher inflation is often blamed on Trades Union profligacy. However, this type of analysis does not get to the root cause of why Australia has suffered from stagflation, whereas many of its leading trading partners have avoided the combination of higher unemployment and higher inflation. A better explanation of recent trends in the economy is that the cause of stagflation in Australia lies with the implementation of inappropriate macro-economic management policies. In other words, there is nothing peculiar to the Australian economy which has made it more susceptible to stagflation than other countries. The difference lies rather with official economic policy.

The reason Australia's inflation rate has risen over the past year, both in comparison to previous years and in relation to inflation in other countries can be directly related to official economic policy. The Australian authorities have intentionally allowed monetary growth to remain at high levels. The announced target growth path for M3 was 10% in 1979/80, 9%-11% in 1980/81, 10%-11% in 1981/82 and 9%-11% during the last financial year. In other words there has been no official policy to induce a significant reduction in monetary growth at any stage over the last four years. This contrasts vividly with experience in the US, the UK, Japan and many European countries whose Central Banks have each announced, and enforced, tighter monetary discipline at various times since 1979. The initial consequence of the Reserve Bank's relaxed monetary posture over the last four years was to prolong the upswing in the business cycle into 1980 and 1981, but only at the cost of sustaining a high rate of inflation. Chart 2 strongly suggests that in spite of the severity of the recent recession in Australia, and notwithstanding any transient

AUSTRALIA
CHART 2: MONEY GROWTH AND INFLATION

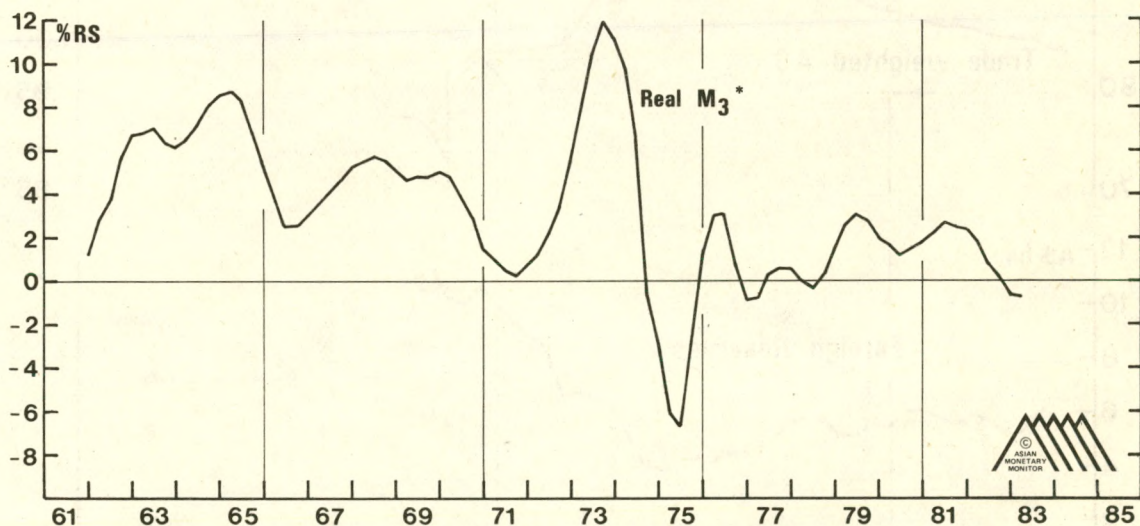
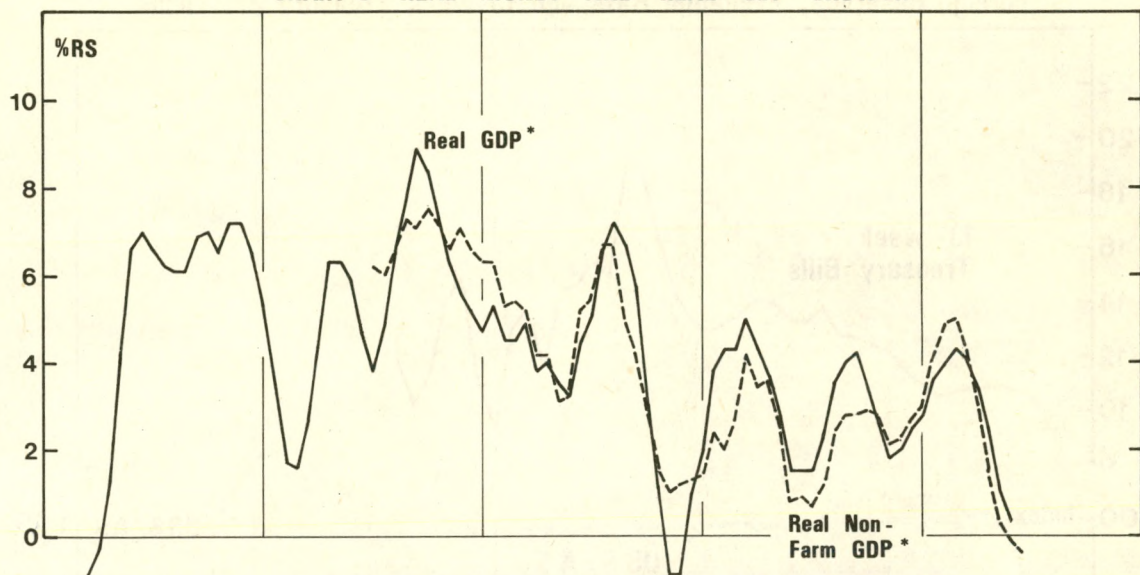


impact of the Labour government's "wages pause" policy, monetary growth has been too high to make any significant decline in inflation over the next year a realistic possibility.

In precisely the same way that official economic policy paved the way for a relatively high rate of inflation, so too did official policy establish the foundation for recession. The prolonged upswing in the Australian economy during 1980 and the first half of 1981, at a time of recession in other leading OECD countries, was directly responsible for the savage deterioration in Australia's current account during that period, and for the associated decline in the net export component of overall real growth. More fundamentally, however, higher inflation during 1981 and 1982 gradually reduced real purchasing in the domestic economy (see Chart 3) and created the squeeze on real incomes typical of the onset of recession. In Australia's case, the recession was undoubtedly exacerbated by the impact of the drought, and by an unusually large cyclical contraction in investment expenditure*, but the ripening conditions for a slowdown in the economy at the end of 1981 can be traced directly to the consequences of an inappropriate macro-economic policy.

* Business fixed investment declined by 15.7% in real terms during the year to March 1983.

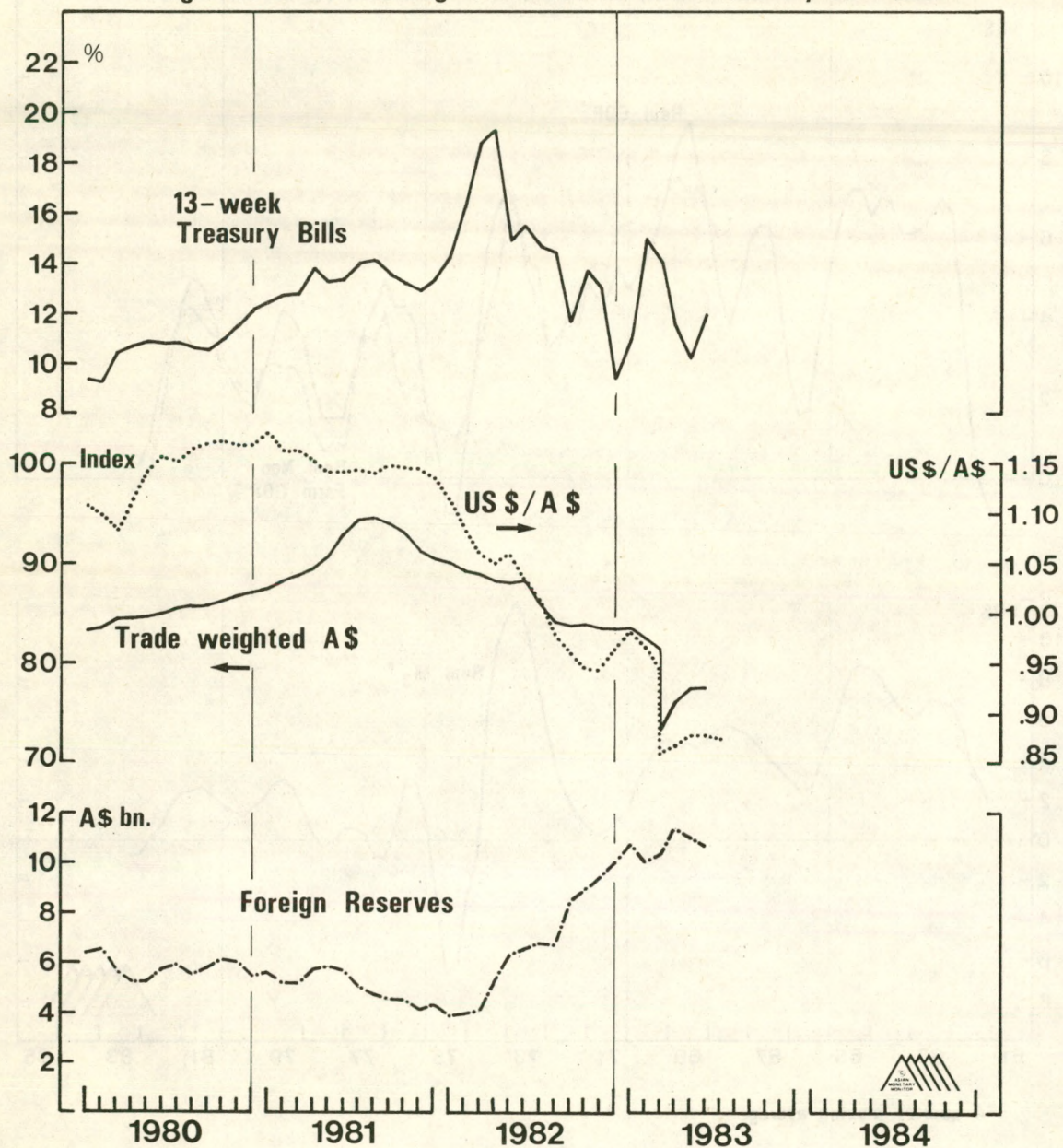
AUSTRALIA
CHART 3 : REAL MONEY AND REAL GDP GROWTH



*4-quarter moving average



Australia : Chart 4
Foreign Reserves, Exchange Rate and 13-week Treasury Bill Yields



Generally one would have anticipated, under a pegged or managed exchange rate regime, that the burgeoning current account deficits of 1981 and 1982 would have encouraged a tightening of monetary conditions in Australia. Under a pegged or, as in the Australian example, managed exchange rate regime one might reasonably expect a swift increase in the current account deficit to lead to a contraction in the Reserve Bank's foreign exchange holdings. This in turn could create reduced growth in the monetary base and an associated decline in the growth of the wider monetary aggregates.

In fact, this indeed was the broad pattern of developments in Australia during 1981 and the first quarter of 1982. As the overall balance of payments turned to deficit in mid-1981, official reserve holdings declined and short interest rates rose from their levels at the start of the year. This process continued, erratically, during the second half of 1981 and encouraged a gradual decline in the year-on-year growth of M3 from 12.8% in June 1981 to 10.6% in December. The crucial policy variable to watch at this time was the exchange rate, for in principle it was always possible for the authorities to depreciate the exchange rate in order to ameliorate any monetary squeeze. However, although the Australian dollar was depreciated against its Trade Weighted Index after August 1981 the decline was only modest. The Australian dollar's trade weighted exchange rate was higher in the fourth quarter of 1981 (91.56) than in the second quarter of that year (91.05) and the Australian dollar/US dollar exchange rate was virtually unchanged over the period.

The relative stability of the external value of the Australian dollar during the latter half of 1981 was a deliberate policy decision. However once the monetary squeeze commenced in earnest, in February and March 1982 - when short interest rates traded above 20%, this policy was rapidly changed. The policy adjustment is clearly illustrated in Chart 4. As the Reserve Bank's foreign exchange holdings plummeted to A\$3,912 million in February 1982 the Australian authorities moved to swiftly depreciate the external value of their currency. Moreover, this policy was maintained more or less throughout the whole of 1982, even as the overall balance of payments position turned to surplus and official reserves climbed to record levels. Whatever else may have been intended by this policy, it was remarkably successful in encouraging a resurgence of private capital inflows which in turn, under a managed exchange rate regime led to a reduction in the level of short interest rates, with three month Treasury Bill yields falling from 19.29% in April to 9.39% in December 1982. Thus, the consequence of official policy to depreciate the Australian dollar was to force interest rates down below the levels they would otherwise have traded at, thereby ensuring that both monetary growth and inflation remained high.

The new Labour Government's official policy to counteract stagflation is enshrined in a Prices and Incomes Accord. Since the general election in March the government has consistently "stressed the need to fight inflation and unemployment

TABLE 1

National Economic Summit Conference: Projections of the Australian Economy

The Conference produced three projections of the economy based on three nominal wage setting assumptions. The nominal wage setting assumptions are:

- A. A 3% increase in nominal wages "later in 1983", followed by full quarterly indexation to consumer prices.
- B. An immediate and full "catch-up" after the recent wage pause, followed by full quarterly indexation to consumer prices.
- C. No wage increases until April 1984, followed by half yearly, partial indexation to consumer prices.

The key results of the Summit's model of the Australian economy are outlined below. Please note that changes in money growth are assumed to reflect a "non accommodative" policy, and changes in the Trade Weighted Exchange Rate Index are assumed to reflect inflation rate differentials.

	Year-on-Year Percentage Change			
	ACTUAL	PROJECTED		
	81/82	82/83	83/84	84/85
Nominal Wage Growth				
A	14.2	11.7	5.5	5.3
B	14.2	11.7	18.1	15.6
C	14.2	11.7	2.8	3.0
Inflation (GDP Deflator)				
A	11.5	9.9	7.0	5.2
B	11.5	9.9	14.4	14.2
C	11.5	9.9	5.9	2.2
Real Growth (Non Farm)				
A	2.4	- 0.3	2.1	3.9
B	2.4	- 0.3	1.1	1.5
C	2.4	- 0.3	2.4	4.5
Money Growth (M3)				
A	11.3	10.5	8.5	8.25
B	11.3	10.5	14.5	15.0
C	11.3	10.5	8.0	5.75
Exchange Rate (T.W.I.)				
A	3.3	-10.6	- 6.6	1.0
B	3.3	-10.6	- 6.6	- 6.9
C	3.3	-10.6	- 6.6	3.9

simultaneously. For that, correct policies, steadily applied over a long period are needed"*. The Australian authorities' notion of the "correct policies" necessary to curtail both unemployment and inflation was displayed at the National Economic Summit Conference held in April this year. The authorities outlined a simple econometric model of the economy which allowed them to contrast the "likely" profile of the Australian business cycle using different assumptions about nominal wages growth. The main results of the Summit model are recorded in Table 1 on page 8. Not surprisingly, the authorities' model suggested that Australia's economic performance under modest nominal wages growth will be superior to that where nominal wage growth is high. The authorities naturally adopted a restrained wage growth scenario (Projection A) as its "preferred option". Nevertheless, one cannot accept this "preferred option" as anything like a full statement of macro-economic policy. The economic projections outlined in the Summit model are, as was officially admitted at the time, purely illustrative, for both monetary growth and the level of the exchange rate were assumed, and there was no discussion of the level of interest rates necessary to ensure that monetary policy will indeed be "non accommodative".

In the absence of any significant decline in monetary growth in 1981 and 1982 it is, in fact, totally unrealistic to anticipate both sustained lower rates of inflation and a sustainable recovery in the Australian economy over the coming year or two. The simplified model depicted in Chart 3 demonstrates that cyclical turning points in the economy are characterised by either an improvement or a deterioration in real monetary growth, which can be taken as a reasonable proxy for generalised real purchasing power within the economy. As a result of the recent severity of the recession in Australia one may perhaps anticipate modestly lower inflation during the balance of 1983, but the trend in inflation is very likely to remain high, in excess of 10%, in line with the growth of M3 over the last four years. If this is the case, the long awaited recovery in the domestic economy can only be achieved if monetary growth is allowed to accelerate from here. The benefits of such a policy would, unfortunately, only prove to be temporary. The longer term consequence of an acceleration in growth from current levels would undoubtedly prove to be yet higher inflation, declining real spending power and only a short-lived recovery. Alternatively, the authorities may attempt to reduce Australia's inflation rate in line with the levels prevalent in many overseas economies. To be successful, such a policy would require much lower monetary growth and would almost certainly have to be accompanied by higher short interest rates and an appreciating currency. A policy commitment to lower inflation in Australia would, however, prolong the current recession and postpone a return to lower levels of unemployment.

* From the text of a speech by the Prime Minister, Mr. Hawke, to the Foreign Policy Association, New York, June 16th 1983.

Which policy option will the Australian authorities choose; one which is geared more towards reducing significantly inflation or one which encourages a recovery in the economy in the near term at the cost, almost certainly, of higher inflation during 1984?

The evidence so far generally suggests that it is the latter choice of official policy which has been implemented. The first clue that the authorities were less intent on reducing inflation and more concerned with generating sufficient domestic liquidity to encourage recovery came with the 10% devaluation of the Australian dollar just two days after the new Government assumed office. In any country where the exchange rate is managed or pegged and domestic liquidity depends mainly on the state of the balance of payments, a currency devaluation represents an effective easing of monetary policy and the devaluation in Australia successfully reduced three month Treasury bill rates from around an average of 14.95% in February to 10.18% in May. Second, and more fundamentally, however, is the evidence from the monetary aggregates themselves. Although the year-to-year growth rate of M3 rose only slightly between March and June 1983, from 12.4% to 12.5%, this annual data camouflages a substantial rise in M3 growth since the start of this year. Seasonally adjusted M3 increased at an annualised pace of 16.6% in the six months to May and at an annualised rate of no less than 25% in the three months following the devaluation of the Australian dollar.

TABLE 2

The Counterparts to Monetary Growth

	A\$ Billion	
	1982/83*	1983/84
Commonwealth Budget Deficit	+ 3.285	+ 8.5
Net Sales of Government Debt to the Non Bank Private Sector	- 3.303	- 4.0
Banking Lending to Australian Private Sector	+ 5.109	+ 4.0
Current Account Deficit	- 5.837	- 5.0
Private Capital Inflows	+ 6.377	+ 4.1
M3	+ 6.631	+ 7.6
Annual Increase in M3	+11.0%	+11.0%

* First eleven months of financial year.

In the light of this effectively accommodative monetary policy it is not at all surprising to find tangible evidence of recovery in the Australian economy. Total unemployment declined from a cyclical high of over 750,000 in March to 680,000 in May, new motor vehicle registrations in April climbed back to the levels of mid-1982, whilst new housing approvals have risen by a seasonally adjusted 14.3% since the beginning of 1983.

Further evidence to suggest that the Australian authorities are in fact more content to risk higher inflation next year rather than risk postponing economic recovery can be found in Table 2, which sets out the counterparts to M3 growth in the first eleven months of financial year 1982/83 and a possible array of the counterparts to M3 growth in this financial year. The key features of Table 2 are as follows. As a result of a large increase in the Commonwealth Government deficit and notwithstanding an assumed large decline in bank lending as a result of the recession, there is a clear bias towards higher M3 growth this year. The authorities must both increase their net debt sales to the non-bank private sector and ensure that Australia runs a deficit on private sector foreign exchange transactions (in contrast to the surplus last year) if M3 is to remain close to the levels of fiscal 1982/83. It is difficult to predict the future levels of net Commonwealth Government debt sales to the non-bank private sector. However it is at least apparent that the authorities must be prepared to appreciate the Australian dollar on the foreign exchanges in order to encourage a reduction in private capital inflows, an overall balance of payments deficit, and a lower level of international reserves if they are to contain M3 growth even to the (excessive) levels of recent years. However, although the Australian authorities have appreciated the Australian dollar, and have allowed the Reserve Bank's International Reserve holdings to stabilise since the devaluation, their moves in this direction have been insufficient to bring about an overall balance of payments deficit. As a result, Australian short interest rates have fallen erratically since March, and monetary growth has accelerated. The slight, tentative appreciation of the Australian dollar in the period since the devaluation and its short term impact on domestic interest rates can only be regarded as part of official economic policy.

FORECAST: In view of existing high rates of inflation and the lack of any significant prior reduction in monetary growth it is unrealistic to expect that the Australian authorities will succeed in curbing both unemployment and inflation in this cycle. If, as appears to be likely at present, the authorities deliberately allow monetary growth to increase then one may anticipate a relatively strong recovery this year but only at the cost of a return to rising inflation and, probably, substantially higher domestic interest rates in 1984.

Although the Australian authorities are likely to follow an effectively reflationary monetary policy this year, this does not rule out the possibility of intermitently higher short term interest rates or a steady or irregularly firmer Australian dollar/US dollar exchange rate. Stock market investors should interpret such developments with care, for they would only signal the authorities desire to contain monetary growth, at an already excessive level, rather than pointing to any meaningful decline in inflation over the medium term.

JAPAN

MONETARY BASE CONTROL IN ACTION

The Bank of Japan's control of the money supply continues to be extremely effective. At a time when most other countries such as USA, West Germany and even (temporarily) Britain have seen monetary growth accelerate sharply, the growth of the monetary aggregates in Japan has remained stable in the 7-9% range (Chart 1). However, although money growth has been steady, there is good reason to believe that liquidity in the economy, or purchasing power in relation to current spending, has been building up steadily. By this measure liquidity is almost as easy as it was in 1978, though it is clearly not as easy as it was in the great liquidity surge of 1971-72, but this time there is no accompanying excess monetary growth. First we describe changes in the monetary base and the Bank of Japan's techniques for managing the base; second we explain some of the linkages between the base and the broadly-defined money supply; and third we consider the increase in liquidity at a time of stable monetary growth.

(a) Changes in the Monetary Base and BOJ Management Techniques

Before 1974 the main determinant of the monetary base and the money supply in Japan was the level of foreign exchange reserves. When the balance of payments was in surplus the Bank of Japan would be a net purchaser of foreign exchange in the market so that foreign exchange reserves would be rising. As a counterpart banks' reserves deposit accounts at the central bank would be credited, enabling them to step up their lending and hence producing an increase in the money supply. Conversely, when the balance of payments was in deficit the Bank of Japan would be a net seller of foreign exchange to the market so that foreign exchange reserves would be falling, and, again as a counterpart, banks' reserve deposit accounts at the central bank would be debited, compelling them to restrict their lending and hence producing a slowdown or a decrease in the money supply.

There were some occasional deviations from this pattern when either the Bank of Japan deliberately offset or sterilised its foreign exchange purchases or sales with sales or purchases of domestic money market instruments, or when the Bank of Japan took specific action to change monetary conditions by altering reserve requirements.

Since the 1973 move from fixed exchange rates to floating exchange rates, and more importantly since July 1974 and the Bank of Japan's switch in policy to controlling the money supply, the main determinant of the monetary base has ceased to be changes in the level of foreign exchange reserves. In principle the central bank is no longer under an obligation to intervene in the foreign exchange market to keep the yen at any

pre-determined level, and therefore the only time* the level of foreign exchange reserves need alter is when the Bank of Japan purchases or sells foreign currency to smooth out short term fluctuations.

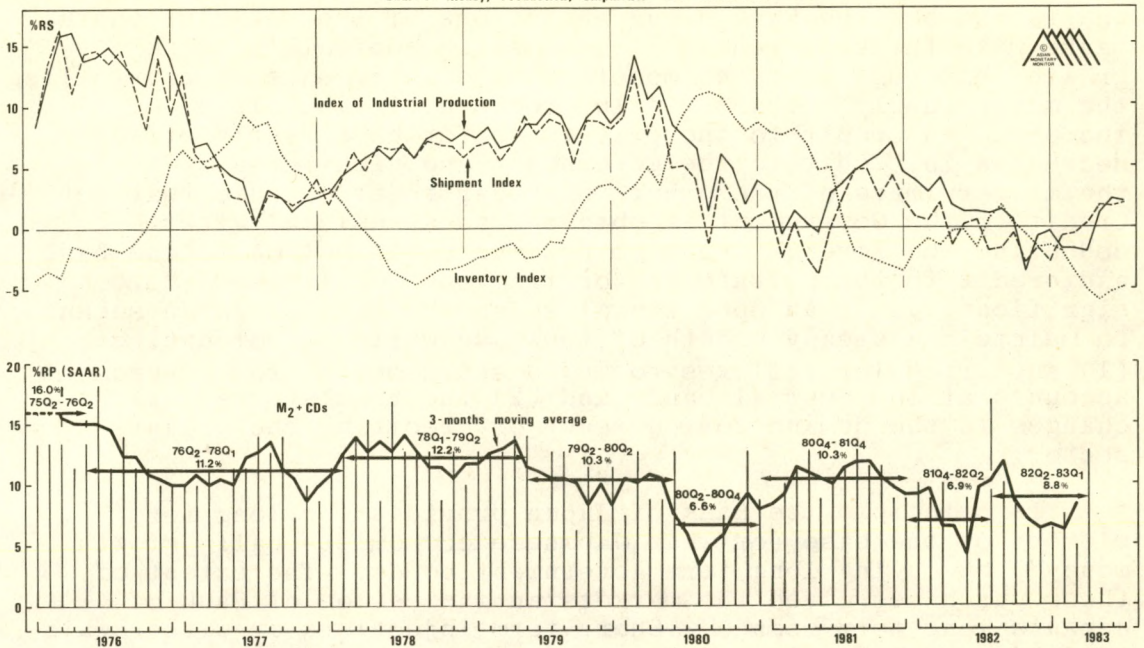
The main determinants of changes in Japan's monetary base nowadays are Bank of Japan purchases or sales of government securities or changes in the level of Bank of Japan credit to the private sector. In the first instance this reflects the fact that the exchange rate is now floating; second, it reflects the persistent government budget deficits since 1974 which have provided a large pool of long term securities for the Bank of Japan to use in its open market operations. Before explaining how the Bank of Japan varies its holdings of government securities and the amount of credit extended to the banking system it is worth noting that in the period up to 1975 Bank of Japan credit was usually the largest component of the monetary base, but since that time credit to the government has gradually taken over as the major source of monetary base creation (see Chart 2).

Assuming Japanese government bond issues continue to be a regular part of the Japanese financial scene and the yen continues to float it is probable that government securities will gradually become a larger and larger component of the central bank's assets corresponding to the base. It is doubtful whether Japan will reach a position within this century comparable to the Federal Reserve System of the United States (where over 90% of the assets corresponding to the base consist of government securities), but such a position is quite feasible within 30 or 40 years.

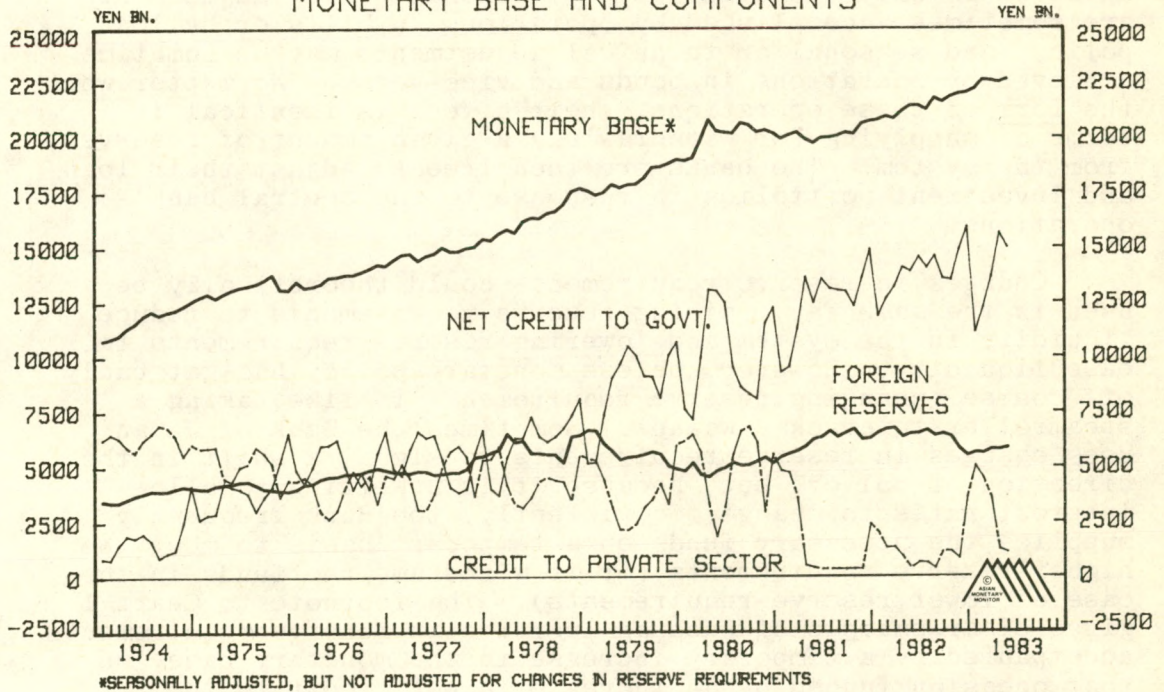
This is a digression from the main theme, but assuming the Japanese authorities were then following responsible anti-inflationary policies (as they are today) so that the yen was strong and economic growth in Japan was steady, an interesting situation would develop - comparable to that of the United States during the later years of the Bretton Wood system - whereby Japan was a major force in international trade with a premium credit rating, yet having minimal foreign exchange reserves. It is likely that by that time many other governments or central banks will hold significant amounts of yen assets as part of their foreign exchange reserves, though this need not be so. Accordingly the yen would be "internationalised" in the sense that it was widely held - and possibly used for trade transactions - by foreigners; and this would be roughly in inverse proportion to the importance of foreign exchange reserves as an asset of the Japanese monetary authorities. In other words, the more insignificant Japan's foreign exchange reserves become as one of the items backing the yen currency, the more internationalised the yen is likely to become.

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* There is in addition the crediting of interest or coupons on the foreign currency deposits and bonds which the Bank of Japan holds, but this has no impact on the size of the monetary base. Neither should changes in the yen-denominated size of the base due to exchange rate fluctuations be counted as having any impact on the base.

JAPAN
Chart 1: Money, Production, Shipments and Inventories



JAPAN
CHART 2
MONETARY BASE AND COMPONENTS



Footnote to Chart 2

The monetary base (or high powered money) is obtained by summing the liabilities of (or money issued by) the monetary authority. The base (continued on p.24)

Returning to our main theme, it is instructive to understand how the Bank of Japan, as one of the world's central banks with the best record of success in controlling monetary growth, has regulated the monetary base as a means of controlling the money supply. Chart 2 illustrates how, since 1974, increases in credit to the private sector have neatly offset decreases in credit to the government and vice-versa. One is the mirror image of the other in the arithmetic sense that Net Credit to the Government is obtained as a residual after deducting the Foreign Exchange Reserve contribution to the base and credit to the private sector from the total base. More significantly, in an operational sense the Bank of Japan seeks to maintain a steady growth of the base while accommodating (1) any irregular influxes to and disbursements from government accounts at the central bank, and (2) the regular seasonal changes in the demand for currency or credit by the private sector.

In principle the Bank of Japan provides the long term element of the base (or what Japanese economists call "growth money") by buying long term government bonds. The extent of these purchases gives the markets an indication of Bank of Japan's long term stance. Short-term injections or withdrawals of funds are accomplished respectively by purchases or sales of short term instruments such as short term government bills, the rediscounting of bills from the bill discount market (equivalent to BAs), by repurchase arrangements or by direct credits to the banks (Bank of Japan credit known as loan policy). This division is only one of principle, so that policy adjustments are sometimes accomplished by operations in bills or by loan policy, and seasonal or technical adjustments may be sometimes achieved by operations in bonds and vice-versa. No matter what the form of these operations, their effect is identical in terms of supplying (or withdrawing) a given amount of reserves from the system. The banks are then free to adjust their loan and investment portfolios in response to the central bank's operations.

Changes in reserve requirements could theoretically be used in the same way, raising reserve requirements to reduce liquidity in the system and lowering reserve requirements to ease liquidity. However, unless monetary policy has got badly off course, changing reserve requirements is like taking a steamroller to crack a walnut. Sometimes the Bank of Japan uses changes in reserve requirements to signal a shift in the direction of policy, but, because it is unwilling to allow interest rates to change too violently, the Bank frequently supplies the necessary funds on a temporary basis to meet the higher reserve requirements (or it withdraws the funds in the case of lower reserve requirements). The footnote to Chart 1 gives clear example of such an increase in reserve requirements accompanied by a temporary increase in the monetary base, on that occasion funded by an increase in net credit to the government.

(b) The Linkages between the Monetary Base and the Money Supply

The money supply (M) is defined as the sum of the deposits (D) held by the non-bank public and cash currency or notes and coin (C) held by the non-bank public.

$$M = D + C \quad (1)$$

The monetary base (B) is defined as the sum of cash currency (C) held by the non-bank public and those assets of banks which are also liabilities of the monetary authority i.e. reserves (R).

$$B = C + R \quad (2)$$

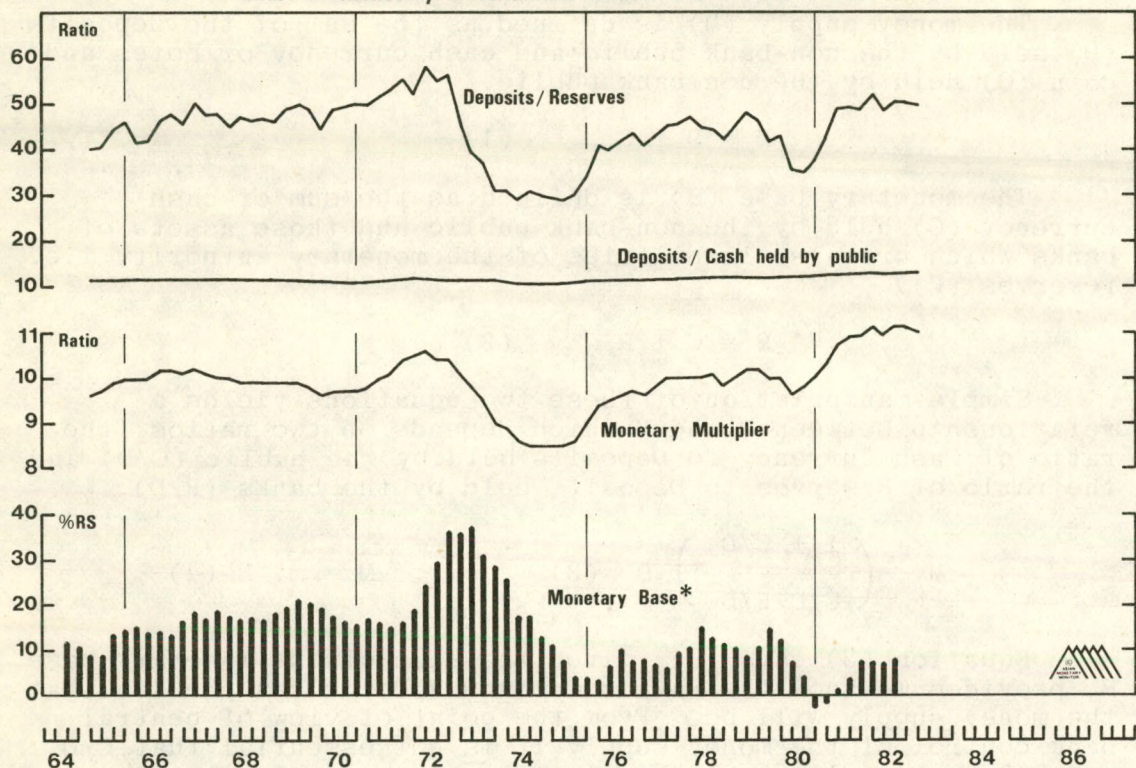
Simple manipulation of these two equations yields a relationship between B and M which depends on two ratios, the ratio of Cash Currency to Deposits held by the public (C/D) and the ratio of Reserves to Deposits held by the banks (R/D):

$$M = \left(\frac{1 + C/D}{C/D + R/D} \right) \cdot B \quad (3) \quad \text{or} \quad M = m \cdot B \quad (4)$$

Equation (3) says that given the size of the monetary base B, provided we know the ratios C/D and R/D, we can predict what the money supply will be. From the point of view of central bank control of the money supply it is not essential that C/D and R/D be rigidly stable; it is only necessary for the two ratios to behave in a predictable way for the central bank to be able to control the money supply. This equation can be related to the familiar credit multiplier of banking theory where R/D in the denominator expresses the potential deposit expansion due to each additional unit of reserves created or supplied by the central bank and C/D represents a restraining influence on that potential expansion due to the cash drain i.e. the absorption in the form of cash currency held by the public of some of the new funds created.

Since B represents central bank behaviour, and since R/D represents the behaviour of the banks, and C/D represents the behaviour of the non-bank public, we can say that the money supply at any point in time is a consequence of the interaction of the behaviour of the central bank, the commercial banks and the non-bank public. In Japan, as in most other countries it turns out that most of the variation in the money supply is due to changes in the base (i.e. due to the central bank) or due to changes in mandatory reserve requirements (R/D) (i.e. the influence of the central bank on the commercial banks), and relatively little is due to changes in the currency-to-deposit ratio (C/D) (i.e. the behaviour of the non-bank public). (See Chart 3.)

JAPAN
Chart 3: Monetary Determinant Ratios and Growth of the Base



* Unadjusted for changes in reserve requirements. The growth of the Base is shown as average changes over the year e.g. the percentage increase between 1981 Q4 and 1982 Q4 is shown in 1982 Q2.

Two further points are (1) that there is no need for the ratio of Reserves to Deposits to be mandatory for this monetary control mechanism to be effective, and (2) that even a small ratio of reserves to deposits (R/D) does not reduce the effectiveness of the control mechanism because, as the table below illustrates, the overall monetary multiplier (m) in equation (4), is roughly equally sensitive to changes in R/D and changes in C/D over the relevant ranges.

Changes in monetary multiplier for given values of C/D and R/D

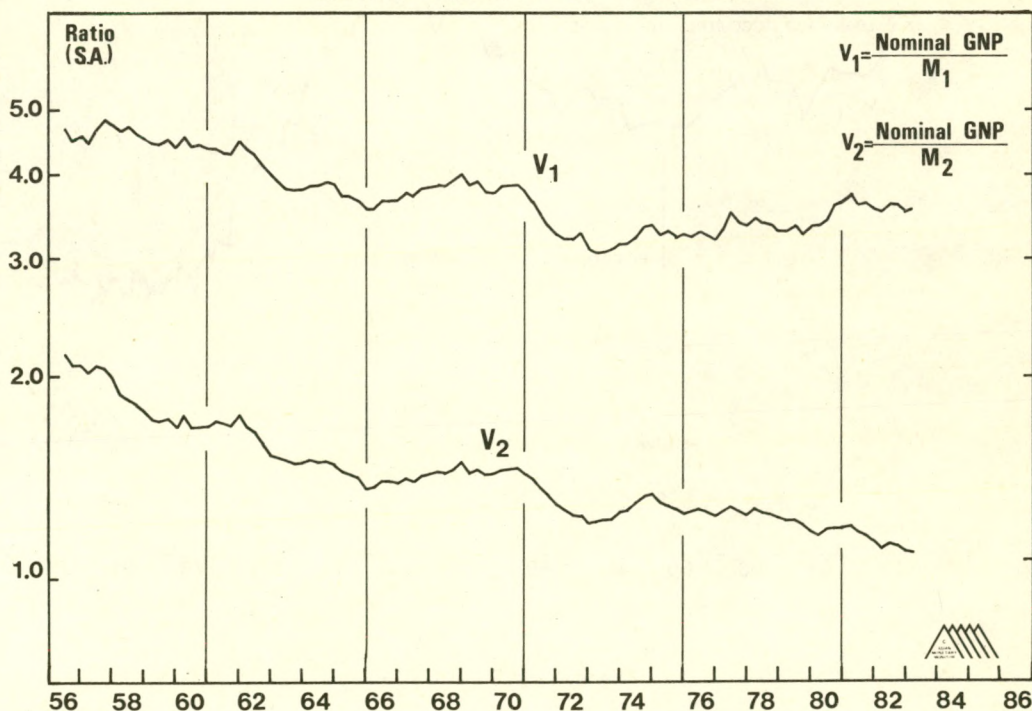
<u>Variations in m for constant C/D</u>				<u>Variations in m for constant R/D</u>			
<u>D/R</u>	<u>R/D</u>	<u>C/D</u>	<u>m</u>	<u>D/C</u>	<u>C/D</u>	<u>R/D</u>	<u>m</u>
100	0.01	0.1	10.000	7	0.143	0.02	7.012
50	0.02	0.1	9.167	8	0.125	0.02	7.759
33.3	0.03	0.1	8.462	9	0.111	0.02	8.475
25	0.04	0.1	7.857	10	0.100	0.02	9.167
20	0.05	0.1	7.333	11	0.0909	0.02	9.836
16.7	0.06	0.1	6.875	12	0.0833	0.02	10.484

(c) Monetary Growth and Liquidity

During the post-war years since 1949, income velocity of circulation or the ratio of nominal GNP to the money supply in Japan has exhibited a strong downward trend, but since the early 1970s that trend has moderated (see Chart 4). Allowing for the trend in velocity, liquidity conditions may be said to be tightening when velocity is rising relative to its trend, and easing when velocity is falling relative to its trend. In simple language velocity rises when spending grows more rapidly than money, and it falls when money grows more rapidly than spending.

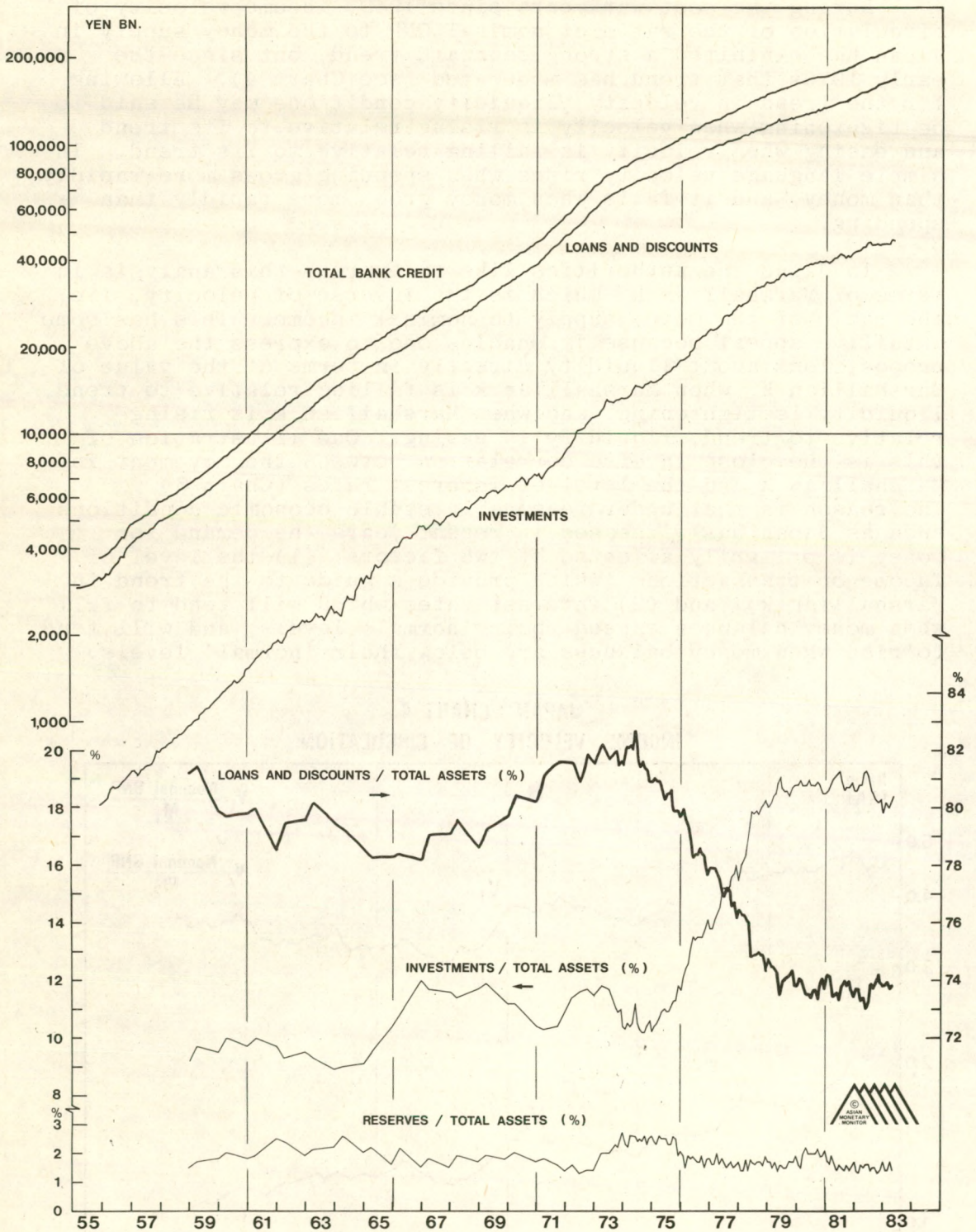
In Japan the authorities like to express this analysis in terms of Marshallian k , which is the inverse of velocity, i.e. the ratio of the money supply to nominal income. This has some intuitive appeal because it enables one to express the above propositions about liquidity directly in terms of the value of Marshallian k : when Marshallian k is falling relative to trend, liquidity is tightening, and when Marshallian k is rising relative to trend, liquidity is easing. One illustration of this is the close inverse correlation between the movement in Marshallian k and the level of interest rates (Chart 6). The reason is that under reasonably stable economic conditions such as Japan has witnessed in recent years the demand for money is primarily affected by two factors: (1) the level of income or transactions (which provide a guide to the trend in Marshallian k), and (2) interest rates which will tend to fall when money balances exceed their 'normal' levels, and will tend to rise when money balances are below their 'normal' levels.

JAPAN : CHART 4
INCOME VELOCITY OF CIRCULATION



JAPAN

CHART 5 : BANK ASSETS



CREDIT CONTROLS OR BASE CONTROL ?

Some observers have argued that monetary control in Japan is only effective due to the existence of credit controls. Without Bank of Japan "Window Guidance" (ceilings on the increments in bank lending) the argument goes, the authorities would not have enjoyed such a record of success in monetary control since 1974. It is true that in the past these Window Guidance controls were important tools in the Bank of Japan's overall control of credit creation, and hence the money supply. Today, however, credit controls are largely in abeyance.

Firstly, this is because interest rates are for the most part no longer kept artificially low, and therefore there is no corresponding need for the authorities to be anxious about excess demands for credit at prevailing rates of interest.

Secondly, the greater flexibility of interest rates in Japan today (see AMM Vol. 4, No. 6 pp. 10-19) permits monetary tightening or easing actions by the Bank of Japan on the monetary base to be transmitted through the money markets to affect the prices and quantities of all types of financial assets, and hence to affect the overall level of spending in the economy. (Tightening actions by the Bank of Japan are not transmitted solely via the banks.) The proposition that credit controls are now obsolete is well illustrated by the tight money policy of 1980 (in the aftermath of the Second Oil Crisis) when banks did not fill their Window Guidance lending quotas. "At the time some people spoke of "tightness without quantity pressure", that is, interest rates worked to restrain investment before quantitative constraints became binding." (See Yoshio Suzuki, "Interest Rate Decontrol, Financial Innovation and the Effectiveness of Monetary Policy," Bank of Japan Monetary and Economic Studies, June 1983.)

Thirdly, the importance of credit controls has been greatly reduced due to the change in the composition of Japanese banks' assets (see Chart 7 opposite). Insofar as credit controls were used by the Japanese authorities in the mid-1970s, one of their main effects was to act as a ceiling on loans to the private sector ensuring that banks channelled funds into government securities rather than to firms in the private sector. In other words the loans ceilings helped to alter the form of bank credit, but they did not necessarily restrict the total amount of credit. (Another perceptible effect of Window Guidance controls was to reduce the market share of those institutions such as City Banks and Local Banks which were subject to the controls.)

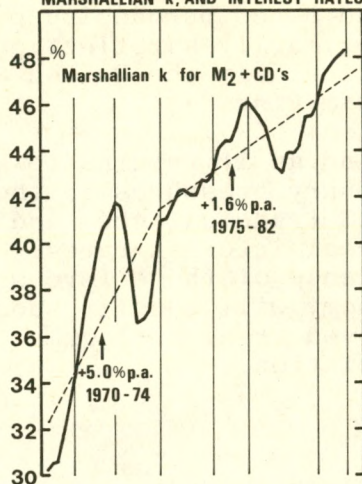
The effectiveness of monetary base control is clearly enhanced by the absence of controls on deposit interest rates and by the availability of a range of financial instruments which the authorities can buy and sell on the open market and through which they can adjust the quantity of reserves in the banking system. However, neither free market rates nor the availability of suitable instruments are a sine qua non for monetary base control. The existence of deposit interest rate controls will simply make the responsiveness of markets and hence the flows of credit more irregular, less predictable, and more discriminatory in terms of their effects on the income of different individuals, firms and financial institutions. If suitable instruments are not available this can be overcome by the use of direct central bank credit facilities, by introducing repurchase or swap agreements on less marketable instruments or - as a short term arrangement - by the issue of interest-bearing notes by the central bank itself. In the early days of deregulation the Bank of Japan used all three of these devices, but, as shown in the accompanying article, they are now a relatively minor adjunct to the primary instruments of monetary base control.

Deviations of Marshallian k from its trend line are shown in Chart 6 taken from a recent study by the Bank of Japan. After the great surge of liquidity in 1971-72 there was a sharp correction in 1973-74 as nominal spending accelerated and as monetary growth slowed down. In 1975-76 Marshallian k was fairly stable about a revised long term trend which sloped upwards more slowly than in the past. (This corresponds to the flattening out of income velocity mentioned above.) In 1977-78 liquidity built up once more, though not to such a great extent as in 1971-72. The background to the build-up of liquidity was Japan's mini-recession of 1977 which meant that spending was growing more slowly than money. Once the economy began to recover in late 1978 excess liquidity began to disappear. Through 1979 Marshallian k declined sharply relative to its trend as expenditures grew rapidly but the monetary authorities began to apply the brakes. In 1980 the economy slowed down in reaction to this squeeze, and before long money was once again growing more rapidly than total nominal spending, resulting in an upturn in Marshallian k relative to trend. The temporary slowdown in the Japanese economy in late 1981 and early 1982 accentuated the upswing in Marshallian k so that today the ratio is some three percentage points above its trend rate of growth, indicating an ample degree of liquidity in the Japanese economy.

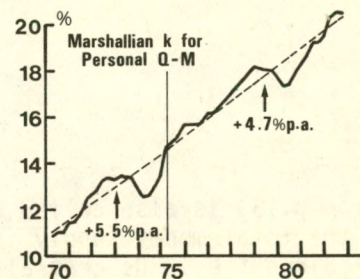
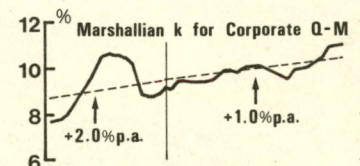
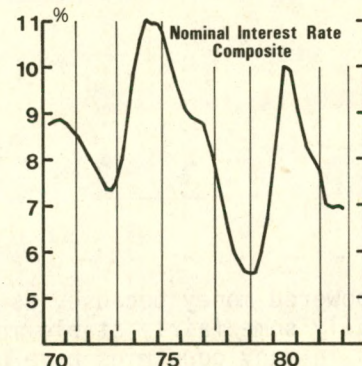
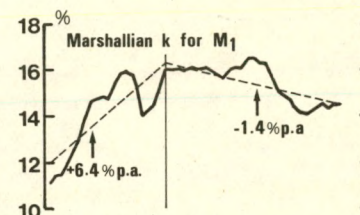
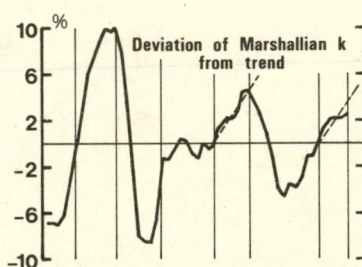
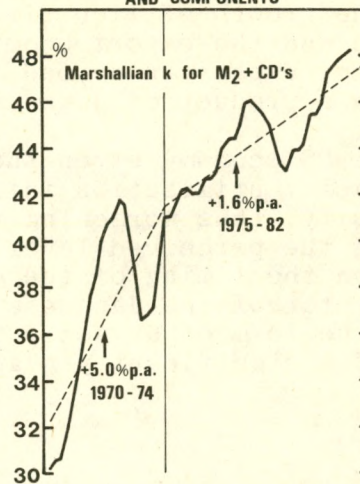
Thus despite a marginal slowdown in the growth of the money supply itself (M2+CDs) from 8.1% year-on-year in the fourth quarter of 1982 to 7.6% in the second quarter of 1983, it is still possible to say that there is ample liquidity. This is because while the current growth rate of money is important, its past growth rate is also important, and the fact that money grew more rapidly for several quarters than was required to maintain Marshallian k at its trend level has meant that the level of the money stock is still slightly in excess of the amount required by the economy at this level of prices and given the existing demand for money.

FORECAST: The mild excess of liquidity in relation to the trend rate of growth of Marshallian k suggests that even without any acceleration of monetary growth Japan should enjoy quite a healthy upswing in domestic expenditures and economic activity during the second half of 1983. The upswing will be healthy in the sense that recent moderate rates of money growth will ensure that there is no resurgence of inflationary pressure as the economy recovers, and it will also be healthy in the sense that no additional stimulus will be necessary to sustain growth at a comfortable level relative to Japan's real growth potential. While these domestic influences are likely to remain quite stable, external influences could be much more stimulative and perhaps even unsettling. A prolonged period of rapid money growth has generated a powerful economic recovery in the United States which is likely to continue well into 1984. This will translate into a formidable upswing in the demand for Japanese exports, while Japan's demand for imports is likely to grow much more modestly. Accordingly it will

JAPAN : CHART 6
TRENDS AND DEVIATIONS IN
MARSHALLIAN k, AND INTEREST RATES



JAPAN : CHART 7
TRENDS IN MARSHALLIAN k
AND COMPONENTS



Source: Bank of Japan, Chosa Geppo, January 1983

Notes

1. Marshallian k is measured as $M2+CDs / (Nominal\ Aggregate\ Demand + Intermediate\ Transactions)$.
2. The Interest Rate Composite is a weighted average of the effective bank lending rate and the Gensaki rate.
3. The correlation coefficient between deviations of Marshall k from trend and the Interest Rate Composite are: 1970-82 -0.67; 1977-82 -0.95
4. All data for Marshallian k are seasonally adjusted.
5. M2+CDs and M1 are month-average data; personal and corporate quasi-money (Q-M) data are month-end data.
6. Trend line of deviation based on 1977-78 episode.

appear that Japan is enjoying yet another export-led boom, whereas the reality is that wise economic management at home has kept the growth of liquidity (and hence purchasing power) restrained, and the export boom is primarily a reflection of the exuberant expansion abroad, particularly the United States rather than a product of Japan's own making.

As the US economy strengthens and as it returns towards fuller capacity utilisation inflationary pressures in the US will intensify, thus worsening the US trade balance, and undermining the perceived level of real interest rates. Depending on the timing of the emergence of these forces the external sector of the Japanese economy will benefit substantially, either in the form of a vastly improved trade performance or in the form of a significant yen appreciation.

(continued from p.15) is also called high powered money because, as shown in the text, the total money supply is usually some fairly stable multiple of the base. Since the 1930s central banks in many countries have used legal authority to impose reserve requirements on commercial banks, and from time to time they have varied those requirements. Such variations clearly alter the multiplier linking the base and the money supply. In order to prevent such changes in reserve requirements from causing sudden large changes in the money supply, central banks frequently offset increases in reserve requirements by increasing the amount of base money (because higher reserve requirements reduce the multiplier), and conversely. The Bank of Japan has usually adopted this offsetting procedure, as it did for example in March 1980. Our unadjusted monetary base accordingly shows a substantial bulge in 1980 (Chart 2), but the monetary multiplier (in Chart 3) dips quite sharply in the first quarter of 1980. It is theoretically possible to compute an adjusted monetary base - that is, adjusted for changes in reserve requirements - but we have not been able to carry out this computation for Japan.

MALAYSIA

EASIER LIQUIDITY WILL BOOST ECONOMIC GROWTH

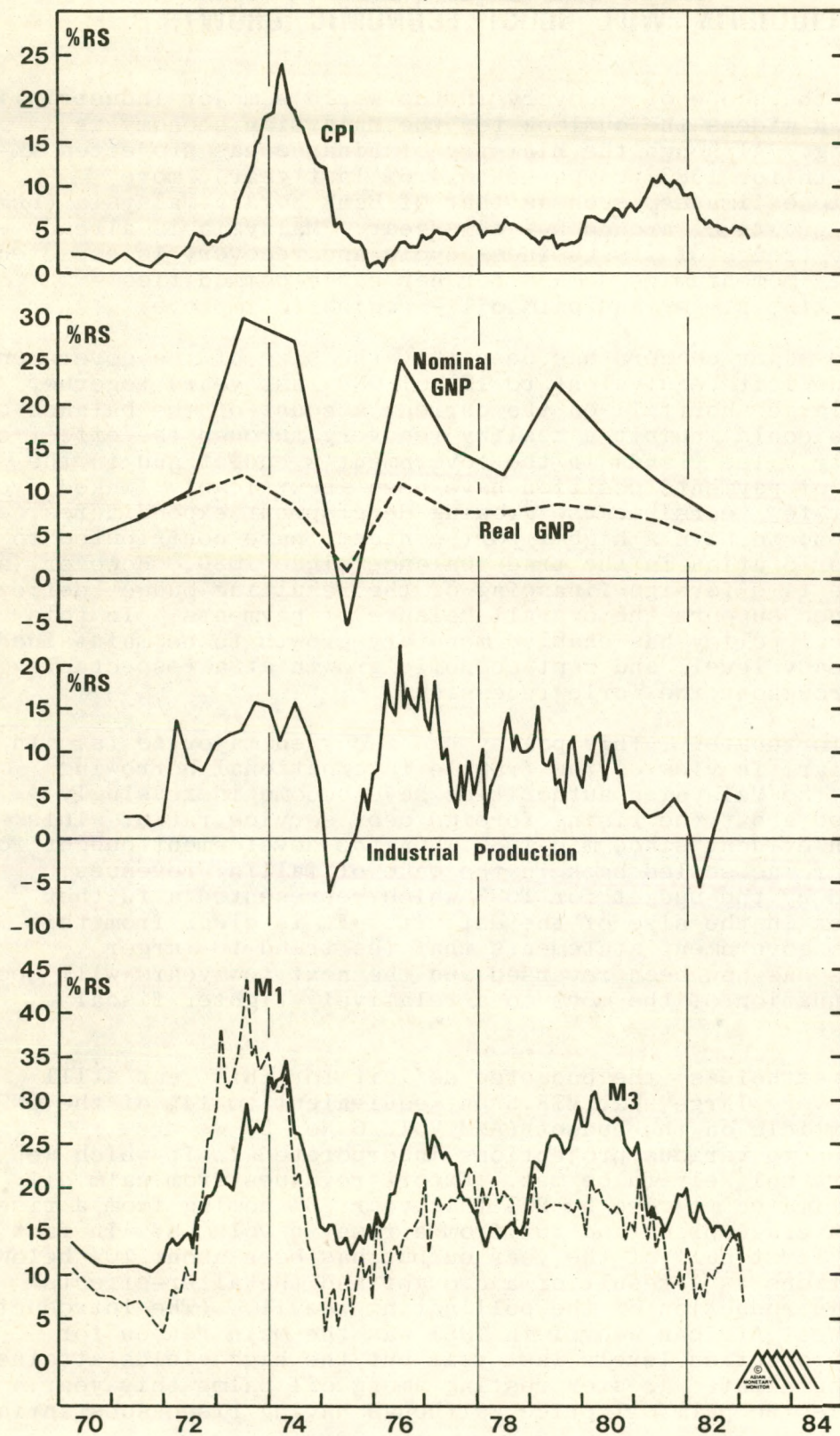
As the scope of recovery in the world's major industrialised economies widens the outlook for the Malaysian economy is improving. Although the Ministry of Finance has projected 4%-4½% growth for 1983 (compared to 4.6% last year), more realistic estimates, such as that of Bank Negara Malaysia (BNM) are for growth of around 5½% this year. Malaysia is already past the trough of its business cycle and recovery is expected to gather momentum as demand for her basic commodities - rubber, tin, timber and palm oil - begins to improve.

The major concern has been that the size of the government's budget deficit (equivalent to 17% of GNP last year) together with a large shortfall on the current account of the balance of payments could inhibit a healthy recovery through the effect on liquidity. The trends in the government's budget and in the balance of payments position have been inextricably linked over the last few years because growing development expenditures, which tend to have a high import content, have contributed to the deterioration in the trade balance since 1980. However, at the same time foreign financing of the resulting budget deficit has helped support the overall balance of payments. In this way fiscal policy has enabled monetary growth to be maintained at a steady level, and kept economic growth at a respectable rate throughout the world recession.

Unfortunately, this policy has incurred major costs. In particular, in view of the fragile international borrowing climate the Malaysian authorities have become increasingly concerned about the rising foreign debt service ratio. This has been evident since mid-1982 when the development budget for that year was scaled back in the wake of falling revenues, followed by the budget for 1983 which represented a further reduction in the size of the deficit. It is clear from this and from government statements that the trend to larger deficits has now been reversed and the next few years will see a continuation of the move to a relatively tighter fiscal stance.

Nevertheless, the budgeted deficit for this year still remains very large - at M\$8.5 bn, equivalent to 14% of the GNP. In an article on the budget (AMM Vol. 6 No. 5) we drew attention to various projections incorporated in it which we felt were unlikely to be met. Export revenues from palm oil were estimated to rise by 21% this year, 6% coming from a rise in the average price and 15% from a rise in volumes. In fact, for the first half of the year output has been about 10% below expectations as a result of a drought and the after-effects of the introduction of the pollinating weevil. (The introduction of the West African weevil in 1981 was the main reason for record production levels last year but the high yields attained have necessitated greater resting among oil palms this year.) Meanwhile the palm oil price, although having risen substantially

MALAYSIA
CHART 1 : MONEY, OUTPUT AND PRICES

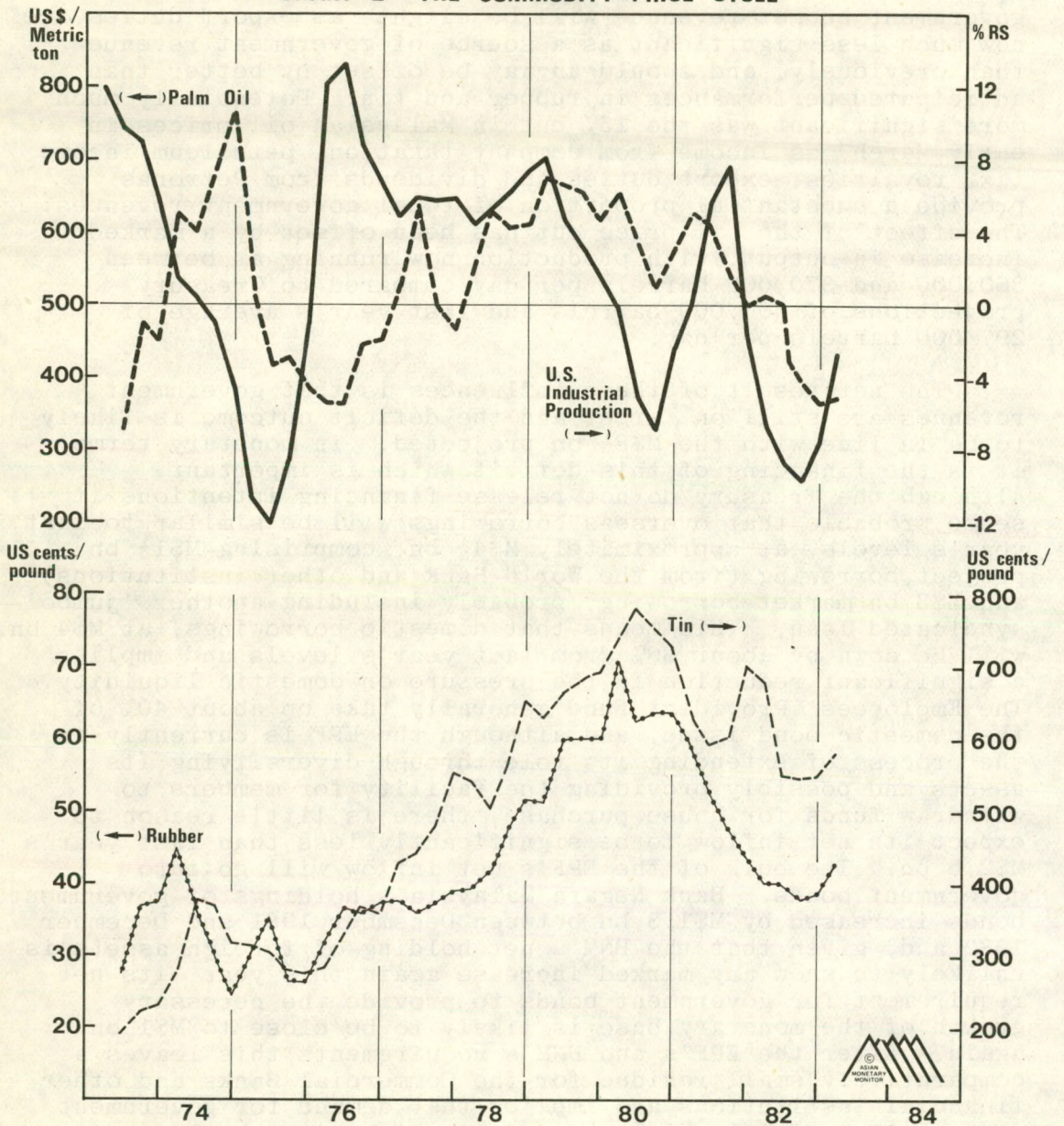


from the September low, seems unlikely to be any higher than last year on a year average basis. However, the impact on government budget revenues will be slight, as export duties are now much less significant as a source of government revenue than previously, and should anyway be offset by better than anticipated performances in rubber and tin. Potentially much more significant was the 15% cut in Malaysian oil prices in early March, as income from company taxation, petroleum income tax, royalties, export duties and dividends from Petronas provide a substantial proportion of total government revenues. The effect of the oil price cut has been offset by a marked increase in output, with production now running at between 360,000 and 370,000 barrels per day compared to Treasury projections of 300,000 barrels and last year's average of 297,000 barrels per day.

The net result of these influences is that government revenues are still on target and the deficit outcome is likely to be in line with the M\$8½ bn projected. In monetary terms, it is the financing of this deficit which is important. Although the Treasury do not release financing intentions it seems probable that overseas borrowings will be similar to last year's levels, at approximately M\$4½ bn, comprising M\$1½ bn project borrowing (from the World Bank and other institutions) and M\$3 bn market borrowing, probably including another 'jumbo' syndicated loan. This means that domestic borrowings, at M\$4 bn, will be down by about 30% from last year's levels and implies a significant reduction in the pressure on domestic liquidity. The Employees' Provident Fund generally take up about 40% of the domestic bond issue, and although the EPF is currently in the process of extending its role through diversifying its assets and possibly providing the facility for members to withdraw funds for house purchase, there is little reason to expect its net inflow to be significantly less than last year's M\$2.5 bn. The bulk of the EPF's net inflow will go into government bonds. Bank Negara Malaysia's holdings of government bonds increased by M\$1.3 bn between December 1981 and December 1982 and, given that the BNM's net holding of foreign assets is unlikely to show any marked increase again this year, its net requirement for government bonds to provide the necessary growth of the monetary base is likely to be close to M\$1 bn again. After the EPF's and BNM's requirements this leaves a comparatively small residue for the Commercial Banks and other financial institutions and implies that demand for government paper will be fairly high and deficit financing should present no problem.

Similarly, the overall balance of payments position is likely to be roughly in balance and thus have little impact on domestic liquidity. The trade balance is expected to return to a surplus, of between M\$¼ bn and M\$1¼ bn. The trade balance moved into small surplus in the final quarter of 1982, largely as a result of the gradual step up in crude petroleum output. With the bottoming of commodity prices in January and the cut in oil prices in early March, the trade position for the first quarter represented a deterioration but it should begin to gradually improve from now on as commodity prices trend upwards.

MALAYSIA
CHART 2 : THE COMMODITY PRICE CYCLE



Rubber, in particular, looks likely to perform well over the coming year. Having risen strongly between mid-January and March, the rubber price has since been consolidating at close to the 'may-sell' level of the International Natural Rubber Organisation, or the level at which the buffer stock manager may begin to dispose of the stockpile. However, after a short further period of consolidation the price of rubber should begin to rise again as demand from tyre makers picks up. Similarly with timber, which should benefit from recoveries in housing starts and the reviving of the world economy. Palm oil should begin to recover properly next year as the developing economies, which form the main buyers in the vegetable oil market, begin to benefit from the widening of the world economic recovery.

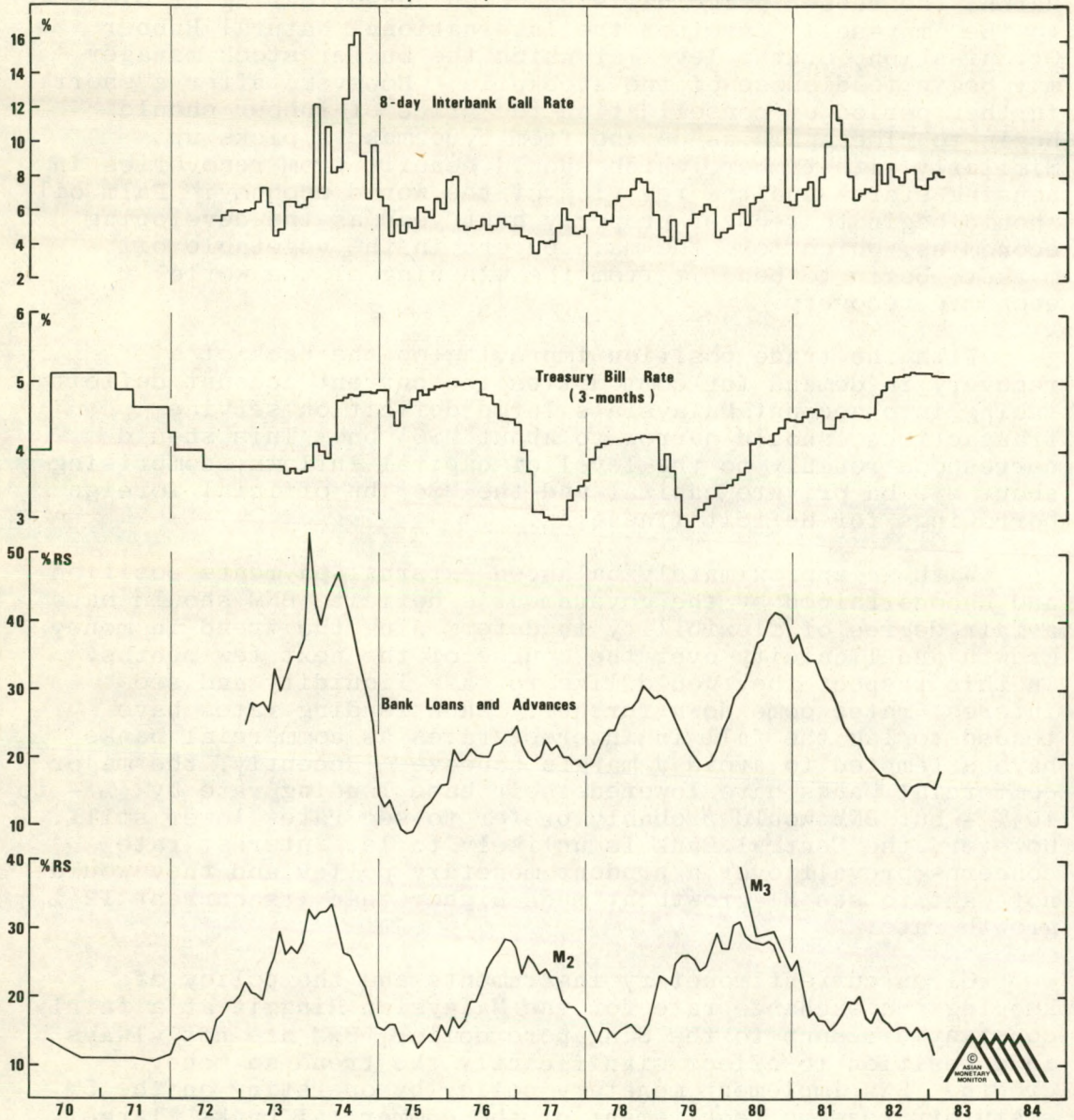
With the trade position improving on the back of a recovery in demand for commodities the current account deficit, taking into account Malaysia's large deficit on service transactions, should narrow to about M\$6½ bn. This should correspond roughly to the level of capital inflows, comprising about M\$2 bn private capital and the M\$4½ bn official foreign borrowings for deficit financing.

With an approximately balanced external payments position and unconstrained by the government's deficit, BNM should have a fair degree of flexibility in determining the trend in money growth and liquidity over the course of the next few months. In this respect they would like to ease liquidity and see interest rates come down further. Bank lending rates have tended to lag the fall in interest rates as commercial banks have attempted to avoid a margin squeeze. Recently, the major commercial banks have lowered their base lending rate by ½% - to 10½% - but BNM would probably prefer to see rates lower still. However, the Central Bank is unlikely to let interest rate concerns prevail over a prudent monetary policy and they would not want to see M1 growth at much higher than its current 12½% growth rate.

Given current monetary instruments and the policy of keeping the exchange rate for the Malaysian Ringgit at a fairly constant discount to the Singapore dollar, BNM are not always in a position to affect significantly the trend in money growth. BNM implement monetary policy by operating on the 5% statutory reserve requirement of the commercial banks, largely through the use of repurchase agreements with commercial banks, currency swaps, the discounting of government papers and rediscounting of export papers. All these measures are more suitable for adding liquidity to the system than withdrawing it, and with the absence of a secondary bond market it is more difficult for BNM to tighten liquidity.

The constraint on BNM acting to restrict liquidity could take on particular significance if the bank continues to follow the relatively inflexible exchange rate policy of keeping the Malaysian Ringgit at a roughly constant discount to the Singapore dollar. Given the Monetary Authority of Singapore's current desire to keep the Singapore dollar tied in a fairly

Malaysia
Chart 3
Monetary Growth, Loan Growth and Interest Rates



narrow range against its US counterpart, such a policy would imply that the Ringgit should stay close to M\$2.30 to the US currency. During the 1970's it was a combination of exchange rate appreciation and over-funding of the budget deficit which kept monetary growth partially under control. With the current size of the budget deficit, the latter option is at the moment not really viable. Thus, unless the BNM allows the Malaysian Ringgit to appreciate it may prove difficult to prevent the emergence of a fully fledged commodity boom, if one should occur, from translating into a large balance of payments surplus and an acceleration in monetary growth.

FORECAST: In conclusion, liquidity should become slightly easier from now and interest rates drop further as BNM marginally relax their monetary stance, although while they have flexibility they will not ease to a degree that would allow any marked increase in monetary growth. However, during the course of next year they may be unable to prevent a monetary acceleration if a sharp recovery in demand for commodities leads to an improvement in the balance of payments. A further contraction in the size of next year's fiscal deficit - which will probably be announced in the budget in October - would have some offsetting influence either by opening up the opportunity for domestic overfunding or, more probably, by leading to a reduction in government overseas borrowings. Nevertheless, the relative contractionary effect of further fiscal tightening would not offset the monetary stimulus arising from a substantial improvement in commodities. In this eventuality a rapid monetary expansion would be inevitable given Malaysia's current, largely political, exchange rate objectives.

Although inflation is unlikely to drop further, inflationary pressures are unlikely to emerge at this stage in the cycle. Easier liquidity through the remainder of this year and more rapid monetary expansion next year imply that recovery in the Malaysian economy will be sustained and strengthen throughout 1984.

THAILAND

CAUSES AND CONSEQUENCES OF RAPID MONETARY ACCELERATION

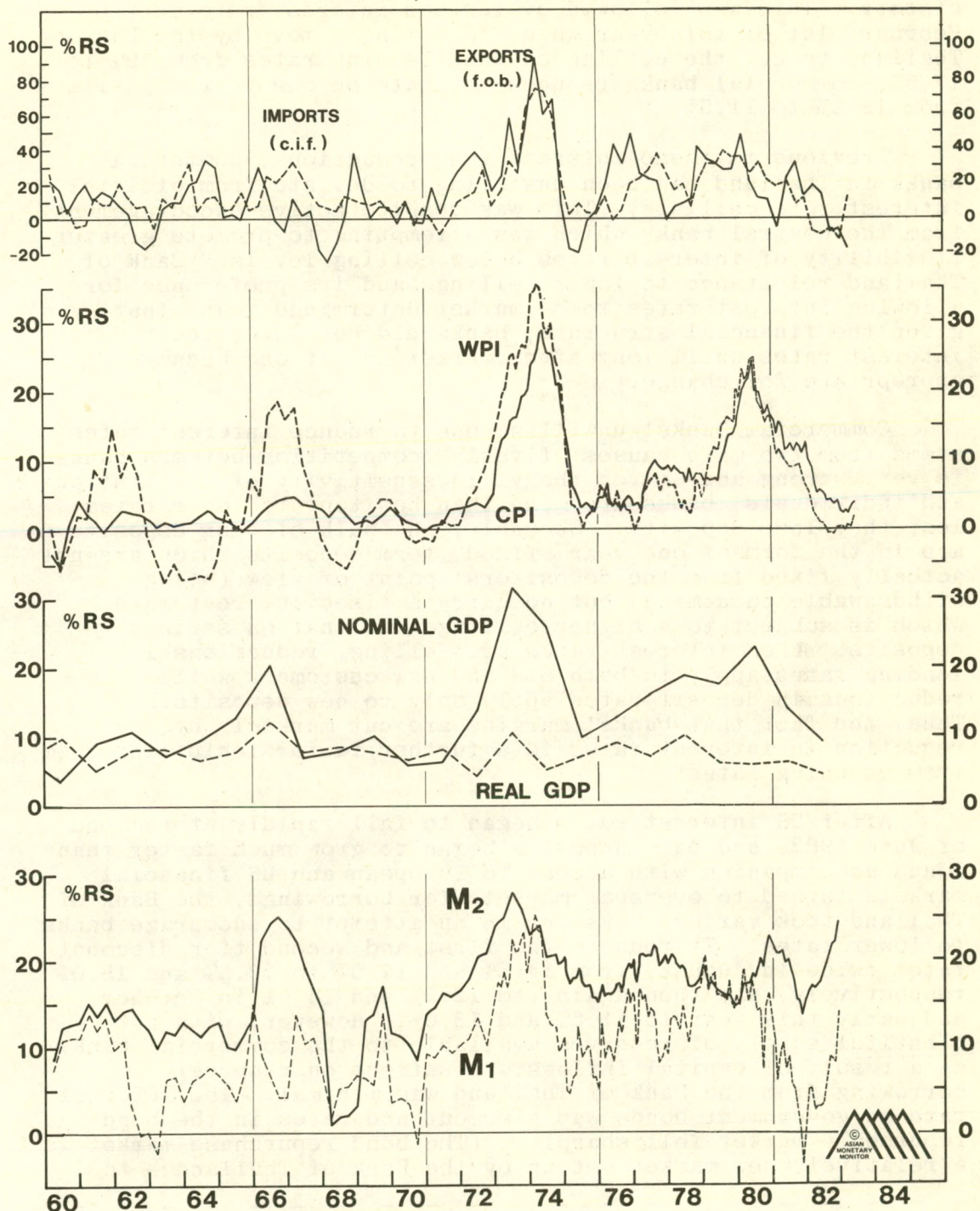
After the severe monetary squeeze of 1981 and early months of 1982, liquidity in the Thai economy has been easing very sharply for the past year. While inflation has fallen - reaching a low of 2.2% year-on-year in March of this year - the growth of all monetary aggregates has accelerated rapidly. The monetary base was growing at a year-on-year rate of 4.2% in March 1982 but by year end had accelerated to a growth rate of 11.2%. The lowest point in the growth of the money supply was actually in November 1981 when M1 was down by 4.0% from the previous year and M2 was growing at a year-on-year rate of 13.6%. However, by the middle of last year while M1 growth was still only 3%-4%, M2 growth had accelerated to 17%-18%. Then in the second half of 1982 there was a rapid acceleration in both monetary aggregates so that by November M1 was showing 13.9% and M2 was registering a year-on-year growth rate of 24.5%. A rate of monetary growth of 25% for M2 represents a higher rate than was reached at the 1980 peak, and the highest rate recorded since the monetary explosion of 1973, and as such demands attention as to its causes and likely consequences.

The basic causes of accelerating monetary growth in Thailand were discussed in an article in AMM Vol. 6 No. 4 entitled 'Why Liquidity is Easing Sharply'. To summarise, this article pointed to the fact that, as the Thai Baht is pegged at a fixed rate to the US dollar (Bt.23.00=US\$1.00), the trend in monetary growth is primarily determined by the trend in the balance of payments (although the government's fiscal position does obviously play a role). In turn, the wide fluctuations in the balance of payments position over the last four years - from large surplus in 1980 to large deficit in 1981 and back to surplus in 1982 - have been principally caused by large swings in the private net foreign borrowing component of the capital account of the balance of payments. Shifts in private net foreign borrowing have resulted from large movements in overseas interest rates since the autumn of 1979 when the US Federal Reserve switched to a policy of money supply targeting with interest rate flexibility. As interest rates in Thailand are very inflexible, movements in US rates were not matched in Thailand and the consequent movements in interest rate differentials led to large flows of capital into and out of the country. Thus in 1981 when US interest rates were at record levels a sharp drop in private net foreign borrowing took the balance of payments into large deficit, and it was not until the fourth quarter of that year when US rates were falling sharply that the balance of payments returned to surplus.

Thus, the course of monetary growth in Thailand has been largely a function of the inflexibility of the exchange rate and interest rates. However, there have been indications over the last few months that the Thai financial structure is becoming slightly less inflexible. In September of last year the large commercial banks reduced their maximum lending rate

THAILAND

CHART 1 : MONEY, OUTPUT, PRICES, AND TRADE



and deposit rate for deposits of one year and over to a level below the official ceiling for the first time in Thai financial history. This was followed by further interest rate cuts on February 1st of this year when, following a move by the Bank of Thailand to cut the ceiling on bank lending rates from 19% to 17.5%, commercial banks reduced the rate on one year deposits from 12.5% to 11.5%.

Previous to these interest rate reductions, commercial banks in Thailand had been unwilling to deviate from official interest rate ceilings. This was despite active encouragement from the central bank, which was attempting to promote greater flexibility of interest rates below ceiling levels. Bank of Thailand reluctance to lower ceilings and its preference for allowing interest rates to be market determined meant that, given the financial structure, banks did not lower their interest rates until long after market conditions became appropriate for change.

Commercial banks' unwillingness to reduce interest rates stems from two main causes: firstly, competition between banks is very strong and, given the yield sensitivity of institutions and individuals, banks are more than hesitant to lower rates lest they lose deposits. Secondly, the bulk of bank deposits are in the form of one year "fixed" term deposits which are not actually fixed from the depositors' point of view (being withdrawable on demand) but do carry a fixed interest rate which is subject to a higher ceiling than that on savings deposits. When interest rates are falling, reductions in lending rates apply to both old and new customers while reductions in deposit rates apply only to new depositors. Thus, the fact that banks' margins are cut markedly by any reduction in interest rates is a further factor inhibiting them from reducing rates.

After US interest rates began to fall rapidly at the end of June 1982, and bank deposits began to grow much faster than loans as companies with access to European and US financial markets turned to overseas markets for borrowings, the Bank of Thailand took various measures in an attempt to encourage banks to lower rates. It reduced the first and second tier discount rate* twice in August, from 14.5% and 17.0% to 13.5% and 15.0% respectively, and then again, to 12.5% and 14.0% in October, and early this year to 11.5% and 13.0%. However, with a plentiful supply of reserves available to the commercial banks as a result of capital inflows, the effect on reserve borrowing from the Bank of Thailand was minimal. The interest rate on government bonds was also cut and rates in the bond repurchase market fell sharply. (The bond repurchase market is a relatively new market set up by the Bank of Thailand - to

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* The first tier discount rate is the rate charged on borrowings from the Central Bank up to the equivalent of 1% of total deposits, with the second tier rate applicable to the second 1%.

encourage secondary trading in government bonds - in which the central bank intermediates between banks to supply banks short of liquidity with funds, with government securities used as collateral). The Bank of Thailand also attempted to create the expectation of falling interest rates by postponing financing of the Treasury's known borrowing requirements. Commercial banks are the only buyers of bonds (to satisfy liquidity requirements) and last year were large buyers due to excess liquidity. It was hoped that postponing Treasury borrowing would create the expectation that such borrowing was to be undertaken later at lower interest rates.

That all these measures were only partially successful was demonstrated by the fact that it eventually took the February lowering of the official lending rate ceiling to bring about a 1% cut in deposit rates to a level more appropriate to international financial conditions at that time. By this time the monetary base had already expanded sharply as a result of US dollar capital inflows attracted by the higher rate available domestically than overseas. Capital inflows were particularly high in December, before the termination of the tax holiday for short-term (less than one year) foreign borrowings which meant that capital brought in in the new year would be subject to 10% withholding tax. The improvement in capital inflows in the second half of the year offset the beginning of a deterioration in the trade account and took the balance of payments for the year into overall surplus of Baht 3.3 bn. The increase in the Bank of Thailand's net foreign assets resulting from this surplus explains more than the total increase in the monetary base between March and December 1982 (i.e. the period of particularly rapid monetary growth).

What are the possible consequences of rapid money growth? Obviously, with inflation at 3%, liquidity is very easy and this implies that the Thai economy is well placed to enjoy a swift economic recovery. However, if money growth persists at these levels the longer term consequences will be inflationary.

The evidence available suggests that, although there may be some slowdown in money growth in the short-term, on average money growth is likely to continue at a rapid rate into the foreseeable future. With real interest rates at such high levels last year, commercial banks' deposits grew by 24.8% while loans only increased by 18%. Banks utilised the excess deposits by acting in three main ways: they increased investment in government bonds, paid back borrowings from the Bank of Thailand, and paid back overseas borrowings i.e. they effectively increased their holdings of "statutory reserves".*

In the eight months between March and November of last year, commercial banks increased their holdings of central

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* Commercial banks are required to maintain 'statutory reserves' equivalent to 7% of total deposits (not including foreign liabilities). Of this at least 2% must be in the form of balances at the Bank of Thailand (part of the monetary base) with the remainder in cash in hand and government bonds.

government securities from an amount equal to 14.5% of total deposits to 16.7% of total deposits. They decreased their liabilities to the Bank of Thailand (i.e. loans and rediscounts) by an absolute amount of Baht 8.0 bn. or from the equivalent of 10.1% of total deposits to 6.3%. Within this total, Bank of Thailand direct loans were reduced from 3.1% of total deposits to 1.5%. Also, commercial banks sharply reduced their borrowings from banks abroad which by the end of the year had fallen to around Baht 20 bn - from an average level of close to Baht 30 bn in 1981.

These latter two actions (reducing borrowings from the Central Bank and from banks abroad) may be seen as somewhat perverse in the light of falling interest rates on these borrowings, but necessary in view of slow loan growth. The net result is that by year end banks had available a supply of reserves with potential to support a large increase in deposits. By increasing borrowings from the Central Bank back to a more normal level banks could acquire the reserves to support a significant deposit expansion. This does not include the reserves that could be effectively created by restoring overseas US dollar borrowings to a more normal level.

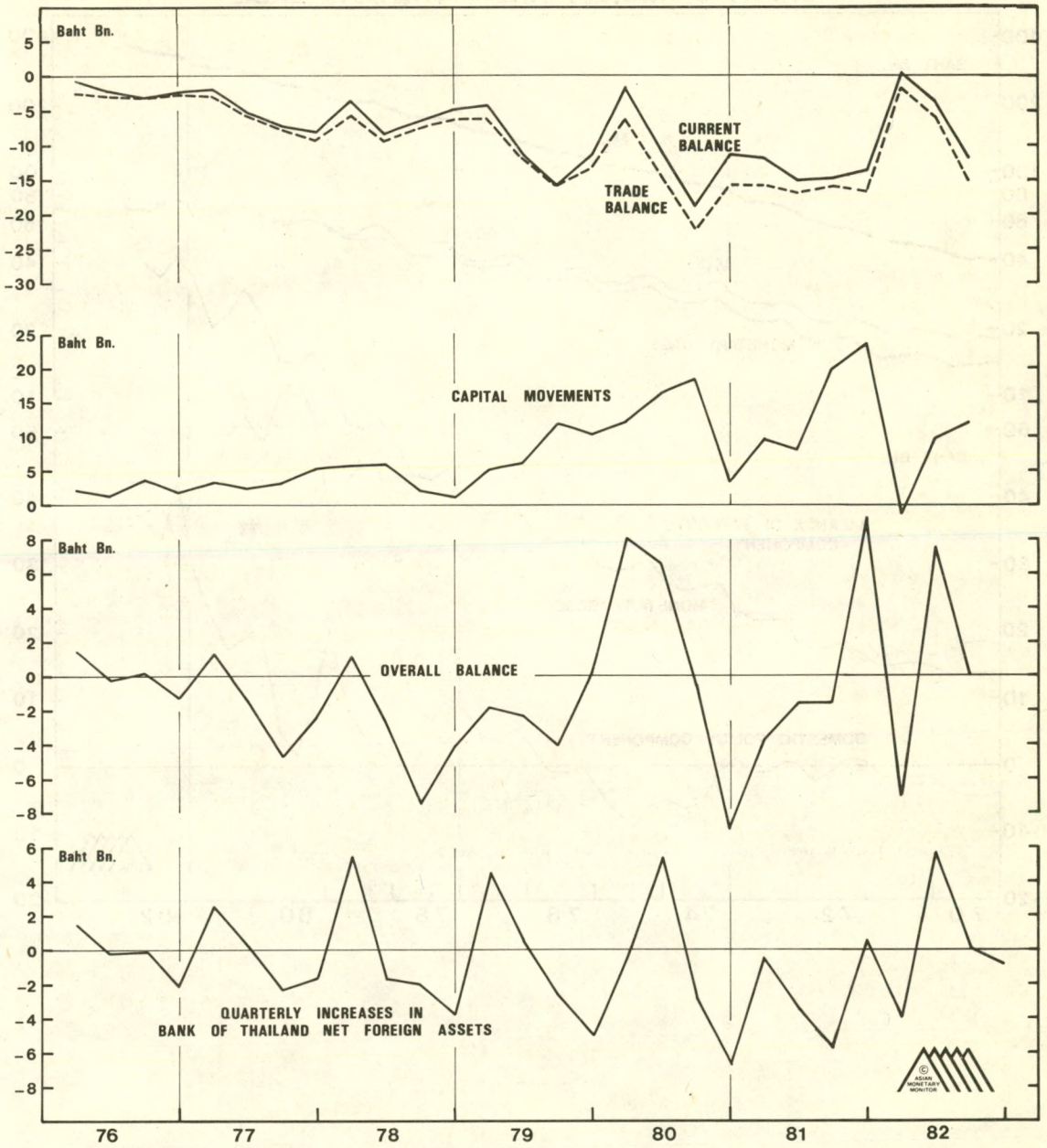
This suggests that, given that domestic interest rates have now fallen the Bank of Thailand will be unable, with the limited monetary tools at its disposal, to prevent a pick up in domestic lending as the economy recovers. The authorities will also be unable to prevent this upswing from translating into a continued rapid expansion in the money supply. However, in the short term there may be some monetary slowdown (or there may have already been at the time of writing given the lag in published statistics) arising primarily from a deterioration in the balance of payments position.

The trade and current account position improved sharply in 1982, with the current account deficit halving in Baht terms from the previous year. A major factor in this improvement was the 8.6% fall in import values which resulted from the tight liquidity and recession of 1981 and early 1982, destocking due to the high level of real interest rates and some substitution of domestic liquified natural gas for energy imports. At the same time, despite the weakness in agricultural commodity markets, export values improved by 4.3% as a result of a bumper rice crop in 1981/82 and the beneficial effects of the 1981 devaluation and various regulatory changes. The current account was further aided by a marked improvement in remittances from Thai contract workers in Saudi Arabia.

However, the improvement in the trade account for the whole of 1982 masks something of a deterioration which began in August of last year and has worsened this year. The trade deficit for the first four months of this year totalled Baht 17 bn compared to only Baht 4.7 bn a year earlier. This deterioration has occurred as year-on-year export growth has turned negative, primarily as a result of a poor 1982/1983 rice crop. Until March year-on-year import growth had also remained negative, but March trade figures were particularly poor as they indicate

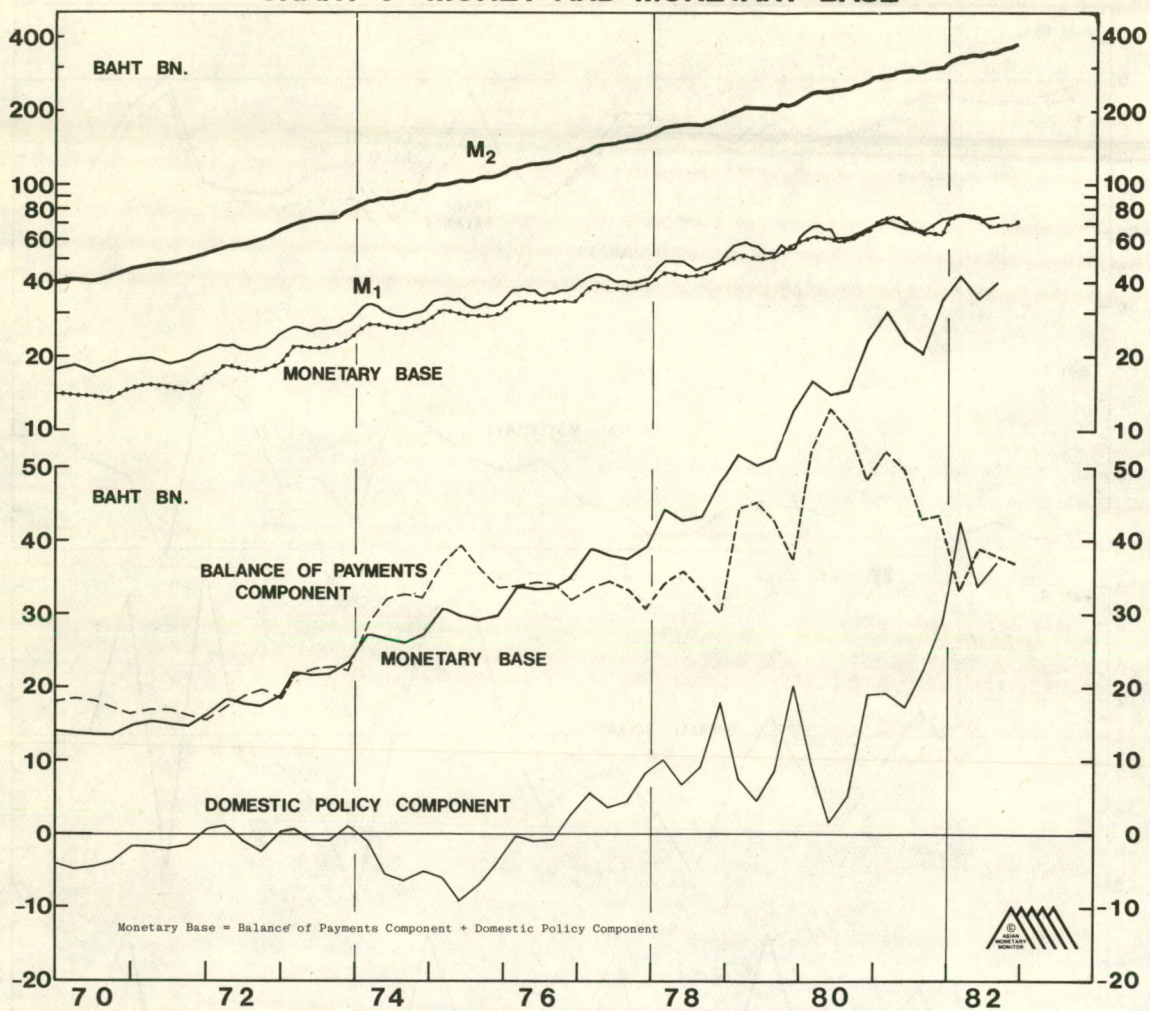
THAILAND : CHART 2

The Balance of Payments and the Bank of Thailand's Net Foreign Asset Position



THAILAND

CHART 3 : MONEY AND MONETARY BASE



exports dropping by 17.3% and imports growing year-on-year by 19.5%. One would expect the combination of recovery in the economy and the February cut in interest rates to lead to some restocking and a rise in import growth, which together suggest a possible further period of weakness in the trade account.

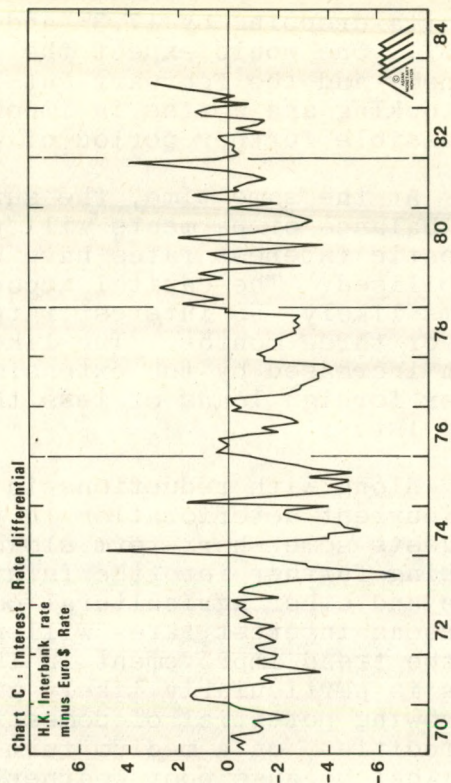
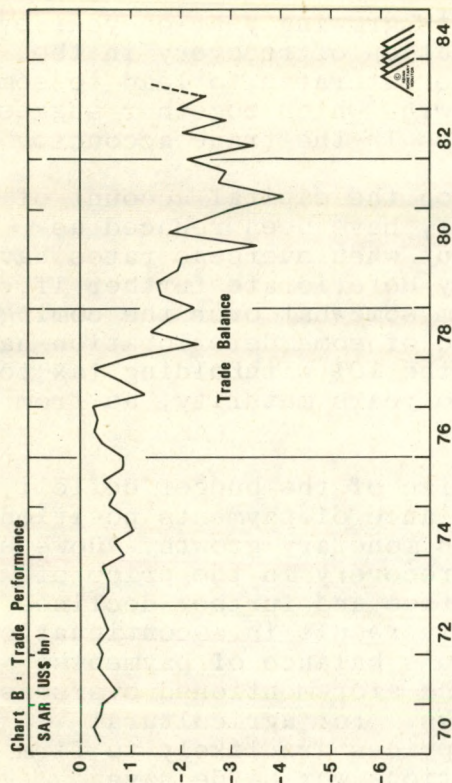
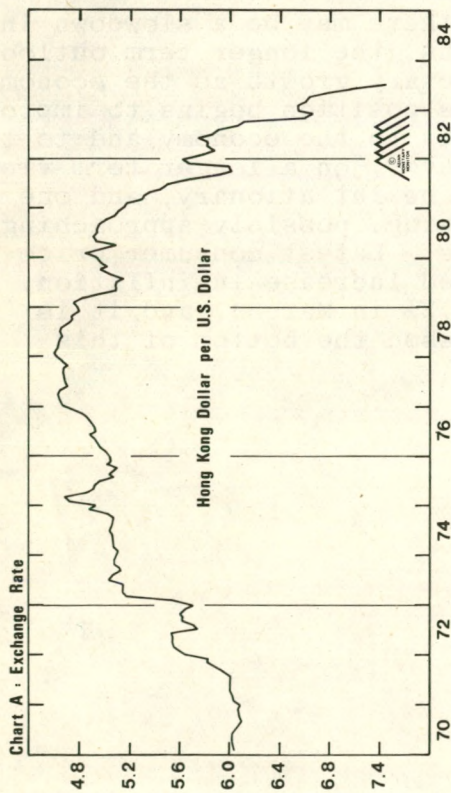
At the same time, the surplus on the capital account of the balance of payments will probably have been reduced as domestic interest rates have been cut when overseas rates have stabilised. The capital account may deteriorate further if, as seems likely, US interest rates firm somewhat over the coming two or three months. The likelihood of some deterioration has been increased by the extension of the 10% withholding tax to cover foreign loans of less than two years maturity, as from July 1st.

Along with reductions in the size of the budget deficit, the current deterioration in the balance of payments position suggests some short-term slowdown in monetary growth. However, looking further into the future, a recovery in the price of rice and other agricultural commodities and further declines in overseas interest rates will probably result in a continuation in the trend improvement in Thailand's balance of payments. This is particularly likely given the aforementioned overseas borrowing potential of domestic banks. For agricultural commodities, on a medium term view prices are likely to firm somewhat because poor weather conditions worldwide have resulted in poor crops. The prices of some foods e.g. sugar have already risen from their lows.

FORECAST: In conclusion, although there may be a slowdown in money growth over the next few months, the longer term outlook is for a continued high rate of monetary growth as the economy recovers and the balance of payments position begins to improve again. This will add further impetus to the economy and to the stock market on a year's view. However, on a longer term view this state of affairs will prove to be inflationary, and one should expect inflation to begin rising, possibly approaching 1980 highs within two to three years. Latest consumer price figures - for April - reveal a marked increase in inflation, to a year-on-year rate of 3.4% (from 2.2% in March), and it is likely that Thailand has already passed the bottom of this inflation cycle.

HONG KONG DOLLAR

40 July-August 1983



April, May and June were months of crisis for the Hong Kong dollar. As confidence in the outlook for Hong Kong's future after 1997 waned, the currency tumbled on the foreign exchange markets: against the US\$ the month-average rate fell from HK\$6.65 in March to HK\$7.26 in June. The lowest spot rate against the US\$ was HK\$7.75 on June 8th. The trade-weighted index for the currency fell from 79.0 in early March to 70.3 on June 8th.

In Hong Kong's peculiar circumstances there was little that the authorities could do effectively to prevent the slide. As explained in earlier issues of AMM, intervention by the Exchange Fund in the foreign exchange market to support the HK\$ does not have the multiple contraction effects which orthodox central bank operations would normally have, and consequently the exchange rate suffered a free fall. The authorities did intervene directly, but apparently without much perceptible effect. However, the authorities also took some indirect action to moderate the downward slide by pressing the banks to raise interest rates by 1% in April and by 2% in May.

The correct policy for a small country with an orthodox banking system facing an exchange crisis is to allow the exchange rate to

fall freely and not to intervene since intervention will only serve to disrupt domestic policy objectives (slowing money growth and raising interest rates). Moreover, a free float rewards those who buy when the currency is cheap because after the crisis the currency will recover. In this orthodox case the ultimate "equilibrium" exchange rate will reflect the stability of domestic monetary policy by returning to its pre-crisis level. However, in Hong Kong's unorthodox case the relationship runs both ways. In the long run the exchange rate can adjust to the money supply, but equally the money supply (and hence the price level) can adjust to the exchange rate.

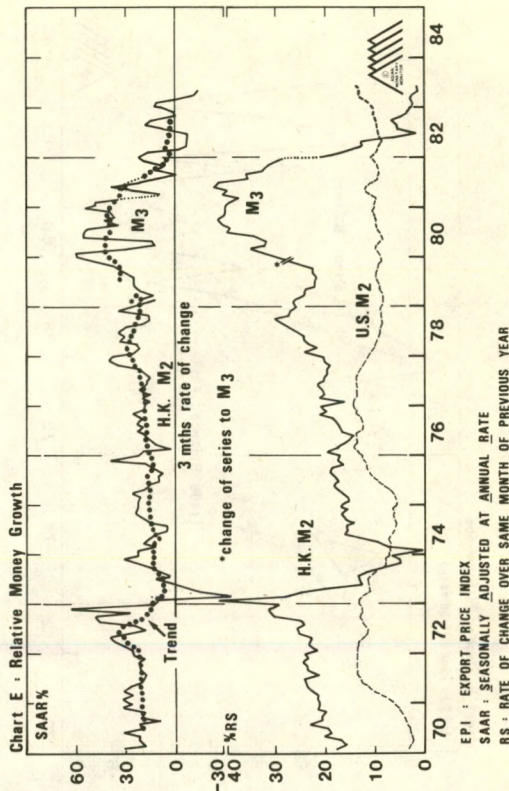
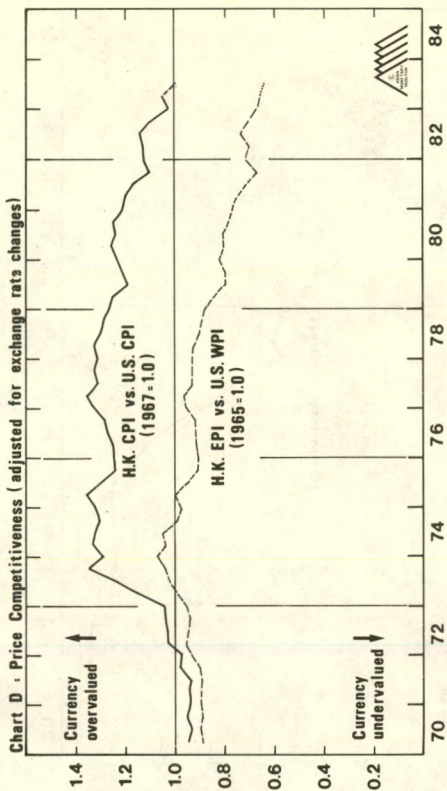
There is therefore no assurance that, even if confidence returns to Hong Kong investors, the currency will recover in the long term. It is entirely feasible that the banks will rapidly lower interest rates, encouraging loan growth and money growth to accelerate, and this will leave the long run equilibrium exchange rate near to its recent low levels.

In the short term, however, there should be some bounce-back when a political solution to Hong Kong's future is negotiated and confidence returns. There are ample signals supporting such a short-term recovery: Hong Kong's trade performance has improved significantly (Chart B), interest rates currently give differentials in Hong Kong the advantage (Chart C), and, most importantly, Hong Kong prices are not out of line with prices overseas - indeed, export prices are highly competitive (see Chart D, dashed line). In addition monetary growth has been restrained (Chart E), even allowing for "swap deposits". However, fundamental considerations must also allow for the peculiarities of the Hong Kong monetary system, and on these grounds one must be sceptical about the possibility of any significant recovery in the currency in the long run.

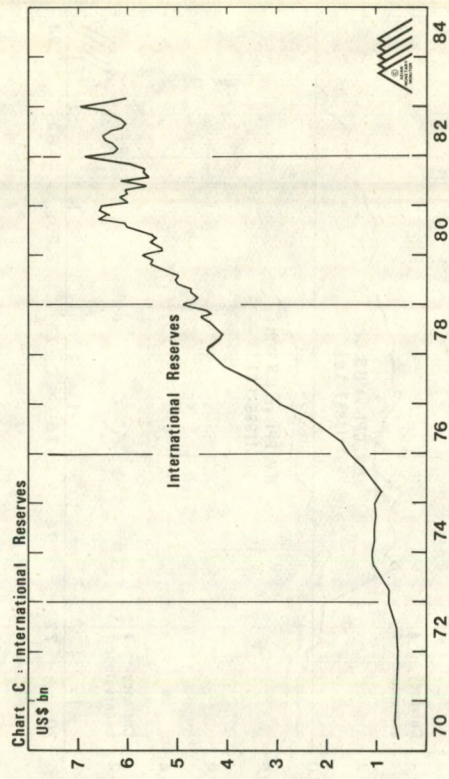
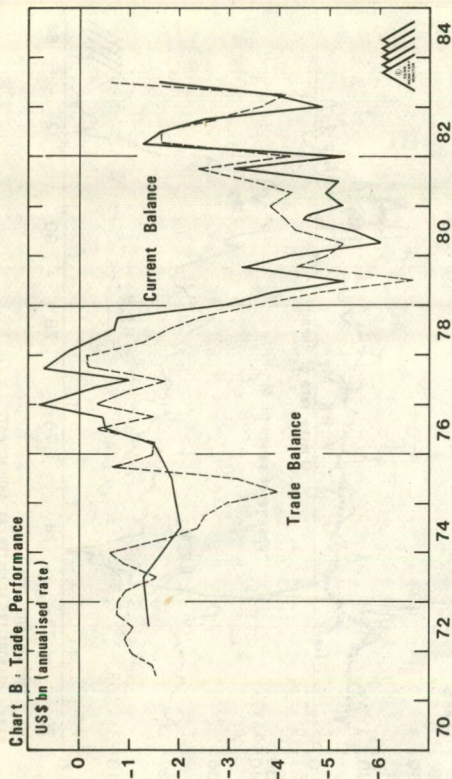
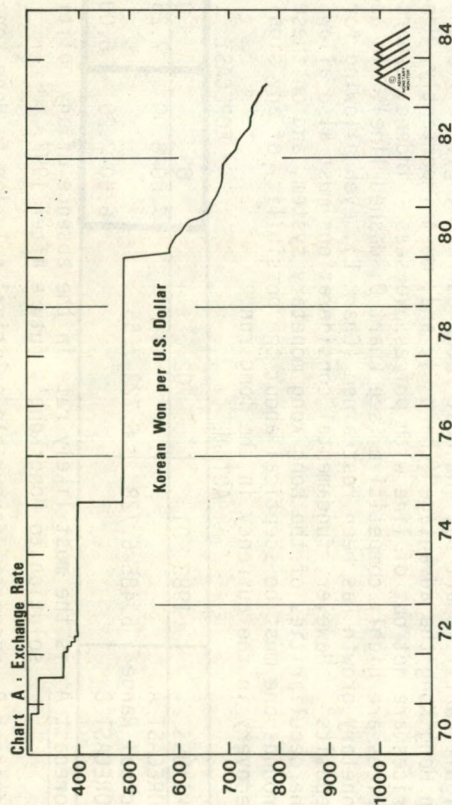
HK\$/US\$	ACTUAL			FORECAST	
	1983	Q1	Q2	Q3	Q4
FORECAST A				7.00-8.00	7.25-8.25
Actual Range	6.485-6.728		6.723-7.55		
FORECAST B				6.50-7.20	6.00-6.75

Forecast A is the most likely rate in the absence of any political solution to Hong Kong's future after 1997.

Forecast B assumes a favourable political solution to Hong Kong's future is achieved before yearend.



KOREAN WON



The Korean Won appreciated marginally against the US dollar during the first quarter of 1983, when the average exchange rate rose to W741.7 from W744.7 in the final quarter of 1982. This represented the first quarterly rise in the Won/US\$ rate since the Korean authorities switched to a "managed" exchange rate after the Won's formal devaluation in January 1980. However this slight appreciation was mainly attributable to pronounced weakness in the US currency following the Federal Reserve's decision to reflate the US economy, and probably does not portend longer term strength in the Won. Indeed, in recent months the Won has again depreciated against the US dollar, sliding to a level of W775 at the end of June.

An important source of weakness in the Won over this period has been the deterioration in Korea's trade deficit. Chart B illustrates the sharp increase in the external deficit - which is once again close to the record shortfalls of the 1979/80 period - since the second quarter of 1982. The quick reversal in Korea's trade account during 1982 stems directly from the increasingly expansionist policies inaugurated at the start of last year. Chart E highlights the surge in Korean monetary growth last year, after the Bank of Korea had foresaken the restrained monetary policy in operation during 1980 and 1981. M2 growth soared from a year-to-year rate of 24.6%

in November 1981 to a peak of 33.6% in September 1982. The result of this policy was successful in its presumed intent of stimulating the domestic economy: industrial production recovered sharply from a trough in the second quarter of 1982, climbing nearly 15% in the year to April 1983. However, the Bank of Korea's unduly accommodative stance also had a further predictable, if unfortunate, consequence. As the recovery in Korea gained strength at a time when many other countries still languished in recession, Korea's trade account swiftly dipped into deficit.

Nevertheless, the outlook for the Korean Won is not unreservedly bearish. During the final quarter of 1982 the Bank of Korea again revised its monetary policy - this time in the direction of restraint. M2 growth has since slowed to 22.4%, year-on-year, and the Bank of Korea has announced a target of a moderate 15% M2 growth for 1983 as a whole. This considerably less accommodative monetary policy is likely to have two important consequences. First, the gradual improvement in Korea's external competitiveness (Chart D) is likely to continue as domestic inflation remains at low levels. (Inflation rose only 3.1% in the year to June 1983.) Second, the Bank of Korea's decision to restrict monetary growth comes at a time when other Central Banks, notably the US Federal Reserve (see Chart E), are easing up. This is exactly the opposite of the turn of events last year and is likely to lead to an improvement in Korea's trade account later in 1983 as import growth moderates and exports pick up in line with the economic recovery overseas. However, until such time as Korea's trade deficit is substantially reduced it is prudent to regard the Won as a weaker currency.

Won/US\$	ACTUAL			FORECAST	
	1983	Q1	Q2	Q3	Q4
FORECAST A					
Actual Range	748.2-763.6	763.3-777.2	830	770-790	780-800
FORECAST B					
				830	830

Forecast A The most likely exchange rate in the absence of a major political or external disturbance.

Forecast B is based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line (using the 1975 base date).

Chart D: Price Competitiveness (adjusted for exchange rate changes)

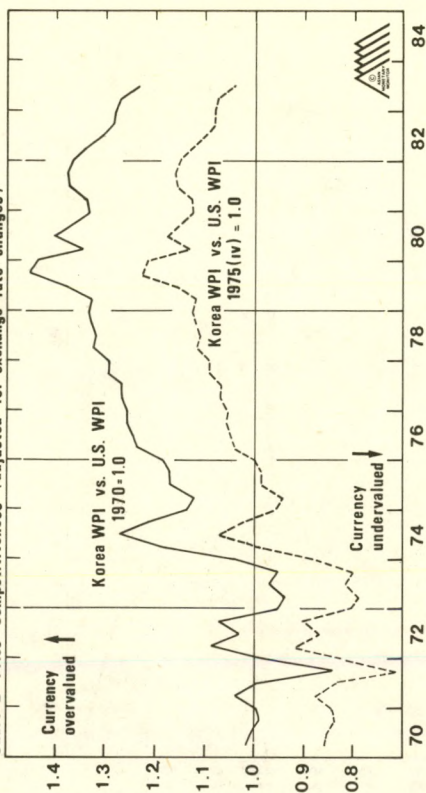
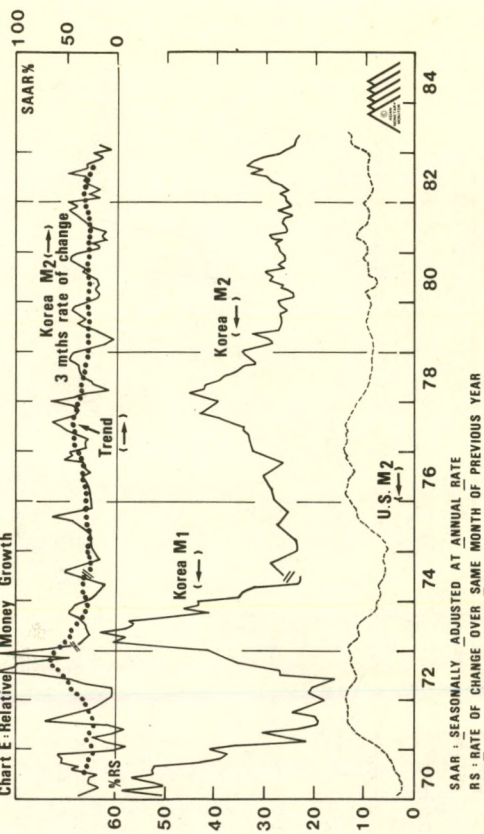
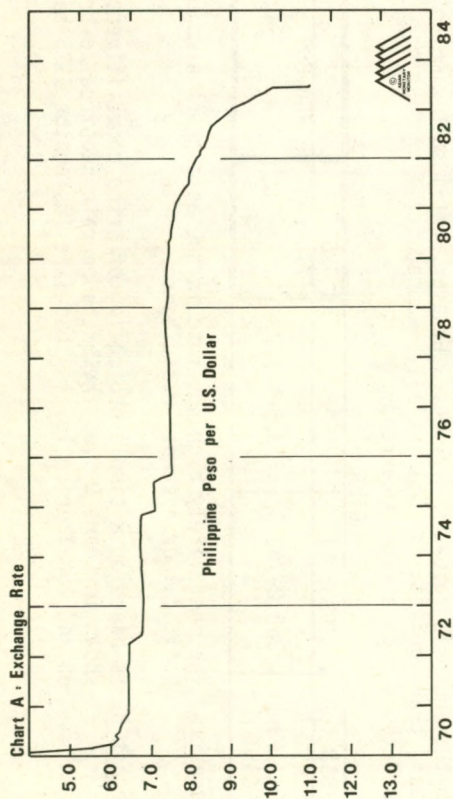


Chart E: Relative Money Growth





The Philippine Peso was devalued by 7.3% from a rate of ₱10.202 to the US dollar to a new rate of ₱11.0, on June 23. The new rate is to be a fixed rate, hence supposedly bringing to an end the Peso's downward slide against the US currency, which began in early 1980.

Although an outright devaluation was probably a sensible move by the authorities, particularly in view of the recent series of devaluations of regional currencies, it seems unlikely that the new rate can be held for much longer than six months. In a previous forecast for the Peso (AMM Vol. 7 No. 1) we pointed to the authorities' lack of room for manoeuvre in economic management given the fragile state of the economy and the need to reduce sharply monetary growth and large budget deficits, while keeping within strict limits on foreign borrowing as well as adhering to various other requirements of the IMF and World Bank. Effectively, the exchange rate remains the only area where the monetary authorities have any flexibility, and thus it would be unreasonable to assume that a pegged rate could be maintained for long, particularly when it still leaves the Peso overvalued on a purchasing power parity basis (Chart D).

The major problem remains the balance of payments. While the

Chart B: Trade Performance
US\$ bn (annualised rate)

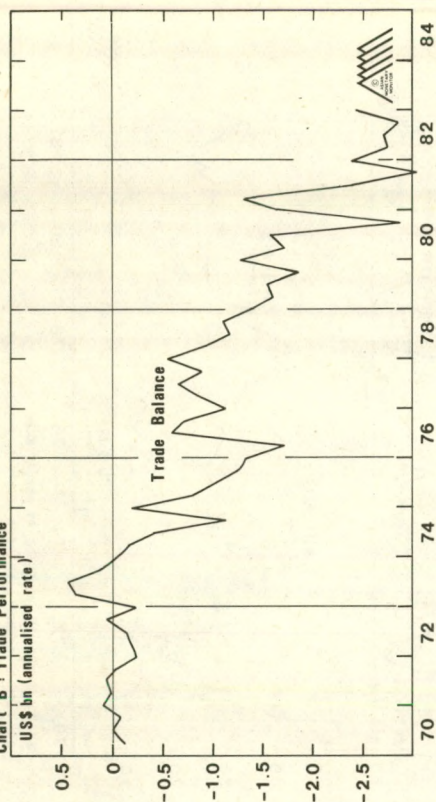
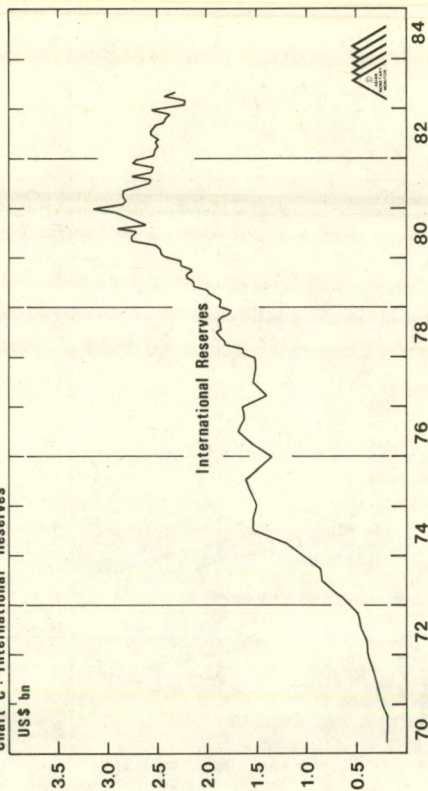


Chart C: International Reserves
US\$ bn



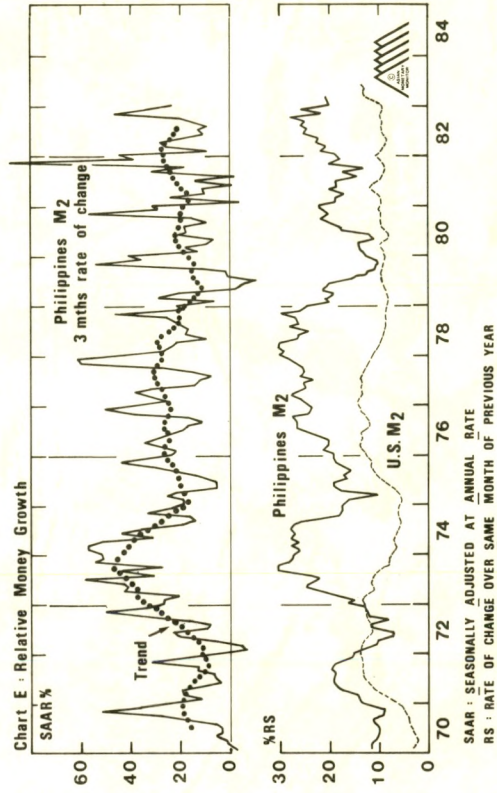
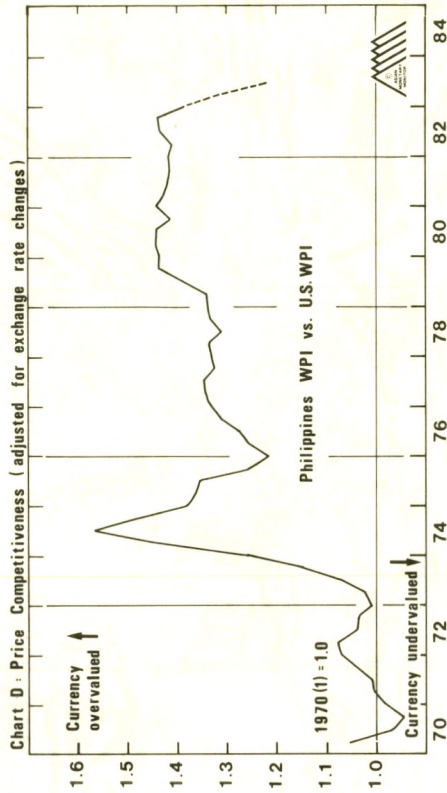
trade deficit for the first quarter narrowed marginally from year earlier levels as a result of a slight rise in commodity exports, import growth remained positive, at 3.1% year-on-year. Despite the state of the economy imports may begin to accelerate as money growth remains high and inflation starts to rise again. Money growth (M2) is currently 20% (Chart E) and it seems unlikely that the authorities will be able to bring it down from this level. Money growth has remained high as a result of monetisation of the budget deficit. Exactly half of last year's deficit, of ₱13.73 bn was financed domestically and with no real possibility of the government borrowing in strained domestic capital markets, this domestic financing was entirely in the form of borrowing from the Central Bank (or monetisation of the deficit). Although the budget deficit is targeted to be lowered sharply to ₱9.4 bn this year, stricter limits on foreign borrowing imply less foreign financing and mean that domestic monetisation is unlikely to be much reduced.

Unless there is a marked recovery in agricultural commodity prices and hence Philippine exports, high levels of monetary growth, inflation and hence import growth will ultimately lead to further devaluation. However, in the medium term the authorities will wish to hold the Peso at its current value and this rate is probably supportable for a few months.

₱/US\$	ACTUAL		FORECAST	
	1983	Q1	Q2	Q3
FORECAST A				Q4
Actual Range		9.173-9.645	9.645-11.0	11.0
FORECAST B				13.0

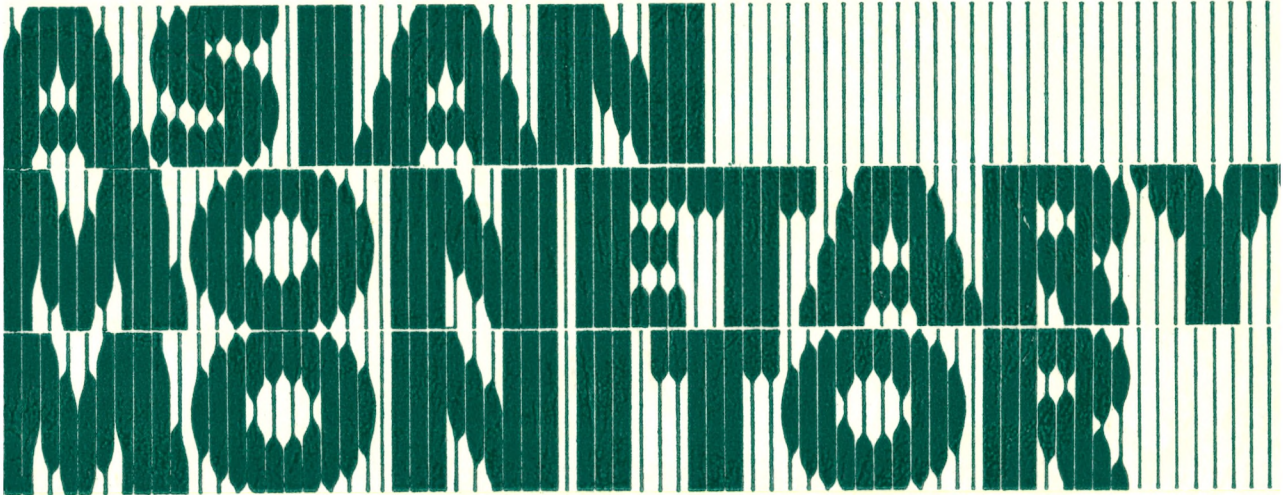
Forecast A The most likely exchange rate in the absence of a major political or external disturbance.

Forecast B is based on a simple projection of price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.





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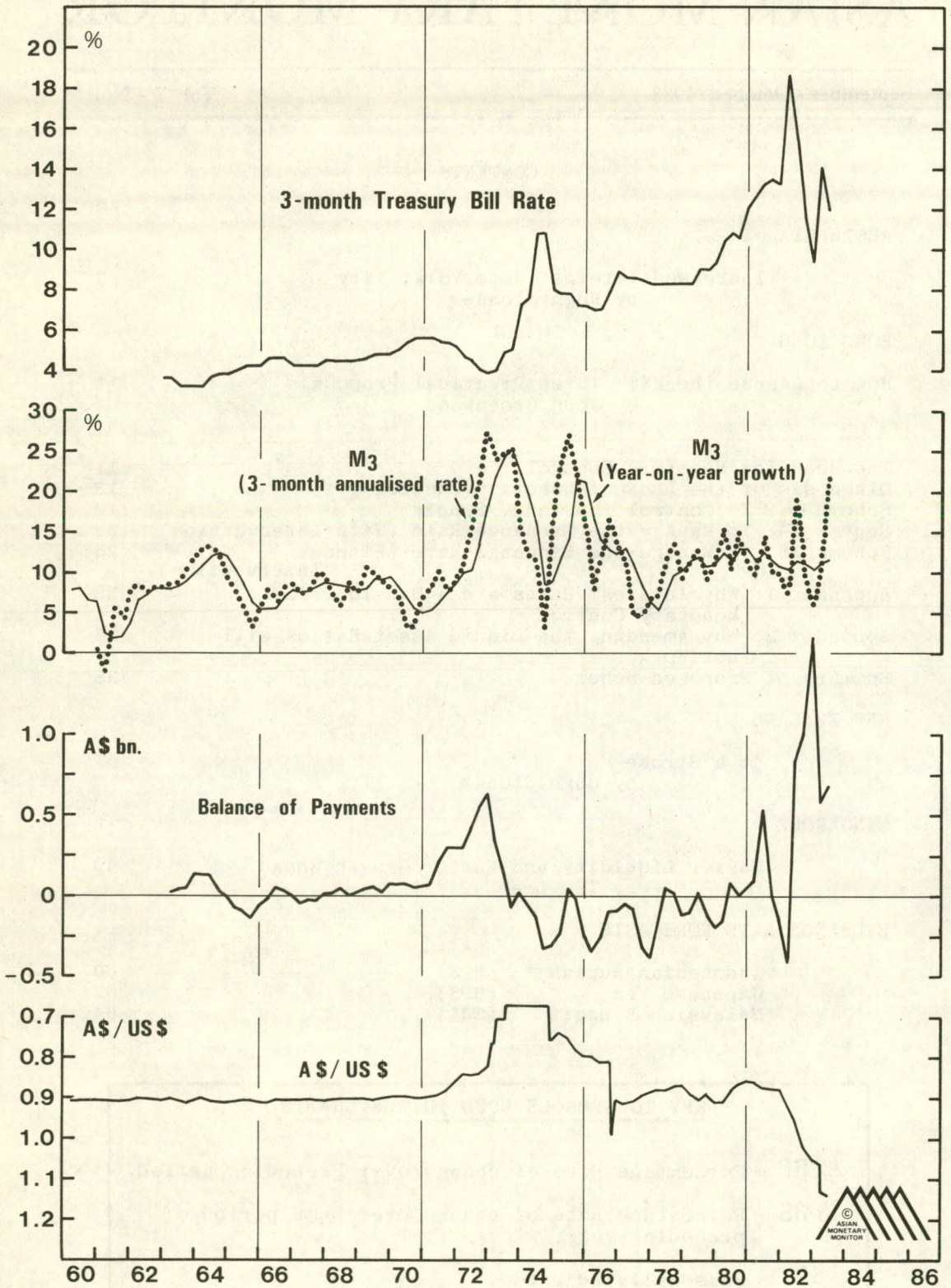
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AUSTRALIA : CHART 1

THE EXCHANGE RATE, EXTERNAL ACCOUNT, MONETARY GROWTH AND INTEREST RATES



AUSTRALIA

INCREASED INTEREST RATE VOLATILITY

Over the past eighteen months both short and long dated interest rates have exhibited increased volatility when compared with the history of interest rate trends in prior business cycles. Australia, of course, is not the only economy to have experienced increased variability in its interest rate structure in recent years and by and large it seems that both monetary authorities and investors have now become used to greater yield volatility. Perhaps one reason for this is that in many economies it is straightforward to identify the source of increased interest rate volatility. The best documented example of this has occurred in the US where an announced change in monetary policy, in October 1979, signalled the start of far greater short term interest rate variability. At that time, the Federal Reserve announced that henceforth monetary policy would be enforced through the control over the growth of banks' reservable assets rather than through the exercise of discretion over the level of the Federal Funds rate. In the future, Mr. Volcker announced, the Federal Funds rate was to be determined in the market. In other words, the Federal Reserve effectively sanctioned greater interest rate volatility as a necessary adjunct to direct control over the growth of bank reserves.

The factors which have led to increased variability in Australian interest rates appear to be less easy to identify. In a certain sense wider interest rate volatility over the past year and a half appears surprising since by two conventional yardsticks monetary policy in Australia has been very stable over this period. The Statutory Reserve Deposit ratio has remained unchanged, at 7.0%, since January 1981 whilst the Liquid and Government Securities ratio has fluctuated in a narrow range between 18.5% and 20.0%. In the past these ratios have often been thought to play an important role in Australian monetary policy with, for example, an increase in the SRD ratio typically signalling higher interest rates and being associated with "tighter" monetary conditions.

In fact, the maintenance of the SRD ratio at any specific level during business cycles in the 1960s and 1970s had only a secondary impact on the conduct of monetary policy in Australia. The key policy variable at that time was the external value of the Australian dollar which was pegged first to sterling, (up until December 1971) then to the US dollar (until September 1974) and finally at a fixed rate to a basket of currencies representing Australia's major trading partners. Throughout this period the principal determinant of monetary policy in Australia, through the fixed exchange rate, was Australia's external position. Changes in the SRD ratio were used, mainly, either to reinforce the impact on domestic monetary policy of the trend in the external account or temporarily counter the influence of the balance of payments.

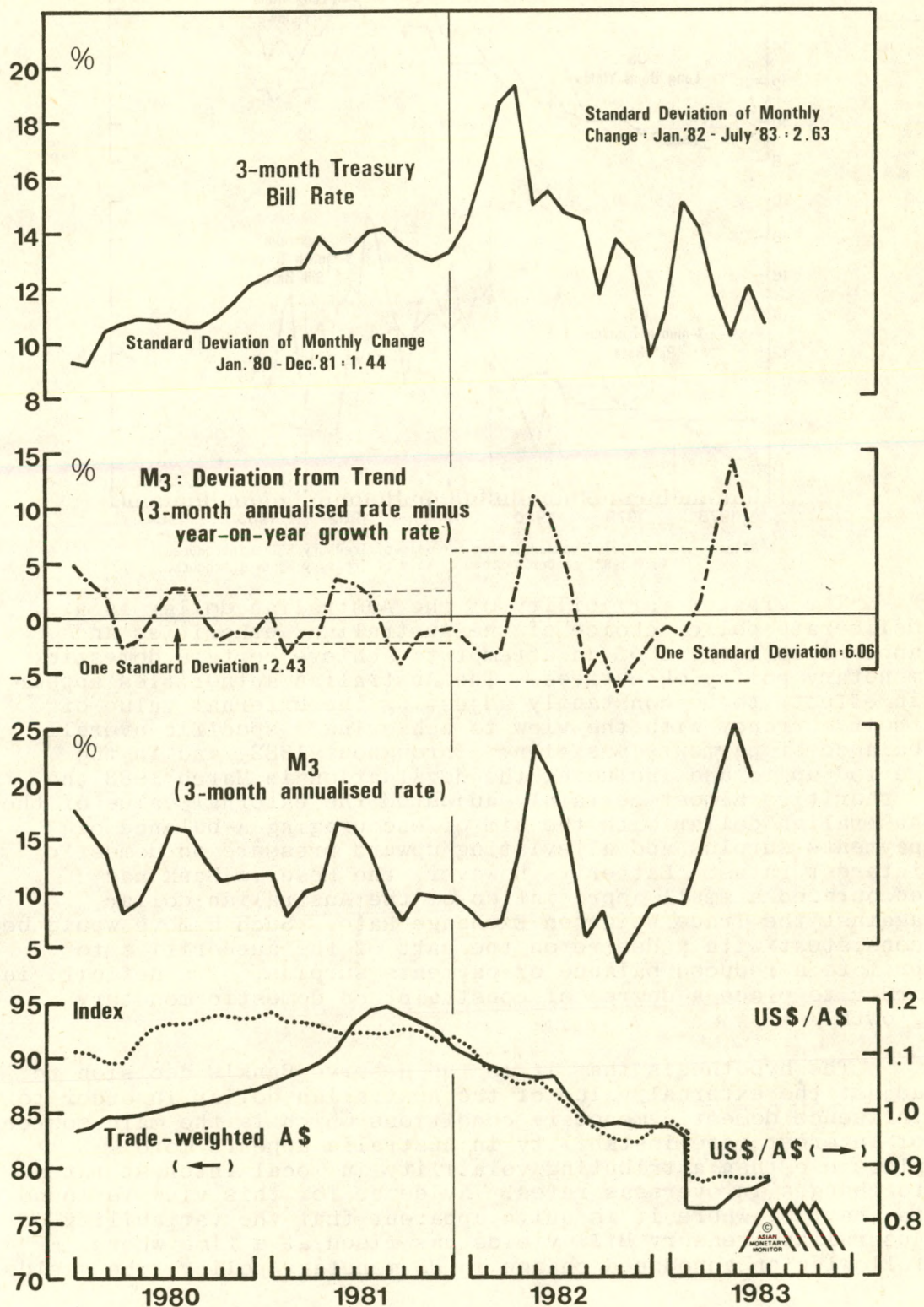
Our basic hypothesis for the increased volatility of Australian interest rates over the last eighteen months is as follows. During the period when the Australian dollar was pegged or, as occurred between early 1977 and the end of 1981, managed in a narrow range, the trend in domestic monetary growth was well defined, with periods of easier monetary policy and periods of tighter monetary conditions lasting for several quarters. Monetary growth may have been cyclical, especially during the mid 1970s, in response to marked changes in the balance of payments position but generally shorter term deviations from its medium term trend were quite small. Thus Chart 1 illustrates that the three month annualised growth in M3 tracked the year-on-year trend quite closely. In this environment, where the trend in monetary growth was clearly defined, interest rates also followed a well delineated course, with few abrupt, month to month, reversals in their direction of change of the type which have been typical over the last year and a half. However, once the Australian authorities began to sanction larger adjustments to the external value of the Australian dollar, the local monetary system was stripped of an important touchstone to stability. One symptom of this policy has been increased volatility in local interest rates.

Some basic evidence for this view is found in Chart 1. When the Australian dollar was pegged at a level that produced an equilibrium in the balance of payments, such as in the latter half of the 1960s, both domestic monetary growth and short interest rates were very stable. When the Australian dollar was pegged at "too low" a level, as in 1971 and 1972, the trend in M3 growth was similarly on a stable and clearly defined but rising trend. Australian interest rates moved steadily lower during this period as successive balance of payments surpluses, under a pegged exchange rate regime, led to a progressive easing in domestic liquidity. This process was reversed after the revaluation of the Australian dollar, to US\$1.4875, in 1973. The swift deterioration in the balance of payments into 1974 brought a corresponding prolonged trend towards higher interest rates, a combination which was repeated again during 1976, and more recently in 1981.

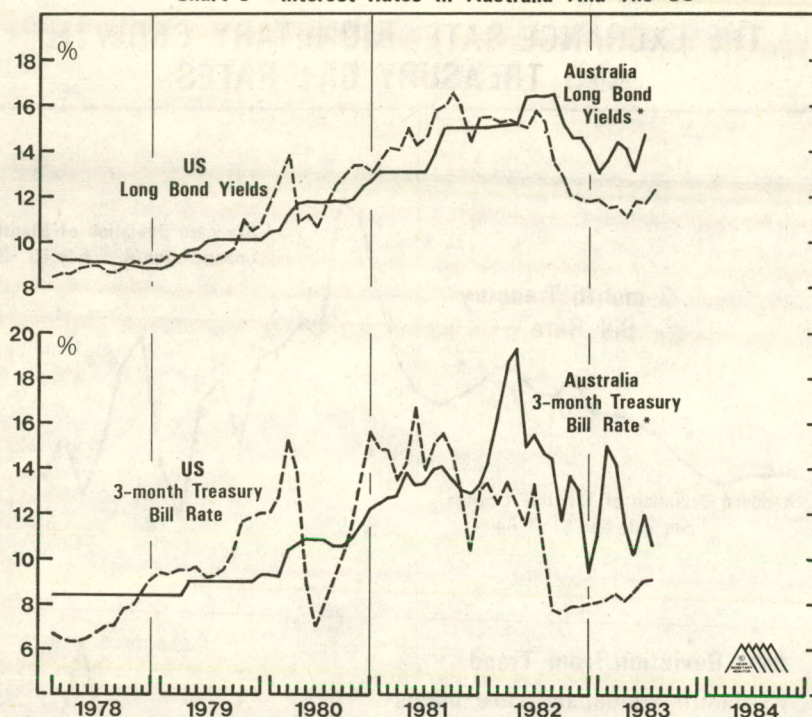
The simple model outlined here - that a pegged or closely managed exchange rate is typically associated, through changes in the external account, with a clearly delineated trend in both monetary growth and interest rates - is not complete. On several occasions, domestic policy initiatives have undermined the influence of the impact of the external account on domestic monetary growth and interest rates. A notable example of this occurred under the Whitlam government during 1975. Nevertheless, the general characteristics of interest rate trends under a pegged or closely managed exchange rate contrast strongly with recent developments in Australia. Chart 2 illustrates how the Australian authorities' decision to allow the external value of the Australian dollar to move beyond a relatively narrow trading range at the beginning of 1982 has been associated with increased monetary and short interest rate variability.

AUSTRALIA : CHART 2

THE EXCHANGE RATE, MONETARY GROWTH AND TREASURY BILL RATES



Australia
Chart 3 : Interest Rates In Australia And The US



*Note: In Dec. 1979, tender system for sale of Treasury Bills introduced.
In Aug. 1982, tender system for sale of Treasury Bonds introduced.

The greater variability of the Australian dollar is a deliberate policy choice of the Australian authorities and appears to be part of an attempt to achieve certain domestic monetary policy objectives. The Australian authorities appear in effect, to be constantly adjusting the external value of their currency with the view to achieving a specific overall balance of payments position. Throughout 1982, and in the period up to and including the devaluation in March 1983 the authorities almost certainly adjusted the external value of the Australian dollar with the aim of encouraging a balance of payments surplus and alleviating upward pressure on domestic interest rates. Latterly, however, the Reserve Bank has encouraged a small appreciation of the Australian dollar against the Trade Weighted Exchange Rate. Such a move would be consistent with a desire on the part of the authorities to promote a reduced balance of payments surplus, or a deficit, in order to place a degree of constraint on domestic monetary growth.

The hypothesis that it is the Reserve Bank's decision to adjust the external value of the Australian dollar in order to influence domestic monetary conditions which is the main source of interest rate instability in Australia appears more plausible than attributing volatility in local interest rates to changes in overseas rates. Evidence for this view is found in Chart 3, where it is quite apparent that the variability of Australian Treasury Bill yields has risen at a time where, following an announced change in US monetary policy, the yields

on short-dated official debt in the US have become much more stable.

An additional source of instability in Australian interest rates arises through the Reserve Bank's manipulation of the forward foreign exchange market. The official forward exchange premium is not a market-determined rate but is established each day by the Reserve Bank and is expressed as a margin from the spot rate. The Reserve Bank may therefore peg both the spot Australian dollar/US dollar exchange rate and the forward exchange premium as, according to our hypothesis, it attempts to target the overall balance of payments position. Chart 4 illustrates the interaction between private sector foreign exchange transactions, the US\$/A\$ forward exchange premium, and local Treasury bill yields. Since May 1982 there has been a close relationship between the costs of forward cover into the US dollar against the Australian dollar and private sector foreign exchange transactions. Hence, whenever the Reserve Bank has reduced forward exchange premiums, making it less expensive to hedge against the US currency, private sector foreign exchange transactions have turned towards surplus.

What is probably happening is as follows. The Reserve Bank simultaneously establishes the spot rate and a forward rate for the Australian dollar. If local and overseas importers and exporters, lenders, borrowers and speculators perceive these exchange rates are "too low", private sector foreign exchange transactions tend towards surplus. Under a managed exchange rate regime this will tend to lead to an increase in the growth of the monetary base, through a rise in the Reserve Bank's net foreign assets, and encourage a reduction in short term interest rates. In principle, reduced short term rates should also encourage a reduction in forward exchange rate premiums*, thus raising the possibility that an additional surplus on private sector foreign exchange transactions will be forthcoming.

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* The Reserve Bank presumably does not establish the forward exchange premium wholly with a view to encouraging or discouraging a surplus or deficit on private sector foreign exchange transactions. It is entirely reasonable to suppose that the forward premium reflects, in some large measure, interest rate differentials between Australia and the US. Nevertheless, it is also clear that the Reserve Bank does not set forward rates in order to run a balanced forward position on its own account. This is indicated by the persistence of fully hedged arbitrage opportunities since the end of 1982. Part of the reason why the Reserve Bank can "set" forward exchange rates in this way is that it limits access to the official forward market to bona fide Australian exporters and importers. These participants must, if they desire to utilise the official market, take out forward cover within seven working days of incurring a foreign exchange risk. Australian banks are strictly excluded from the official market and are therefore unable to arbitrage the risk free returns persistently offered by the Reserve Bank during the last eighteen months. Were trading banks able to enter the official forward market the authorities' attempts to influence private sector foreign exchange transactions would prove far more costly to the Reserve Bank.

(to be continued on next page)

CONCLUSION: We hypothesize that the principal source of interest rate volatility in Australia has been the Reserve Bank's decision, in early 1982, to sanction greater week-to-week and month-to-month adjustments in the external value of the Australian dollar. Prior to that date, the Australian dollar was either effectively pegged or managed within a narrow range against the US dollar or a basket of currencies. Up until the end of 1981, therefore, the Australian authorities effectively pegged the external price of money and generally allowed the quantity of money in the domestic economy to adjust in line with the balance of payments. Monetary growth under such circumstances tended to be cyclical, but each cycle lasted for quite prolonged periods of time and, as a result, the trend in interest rates tended to be well delineated.

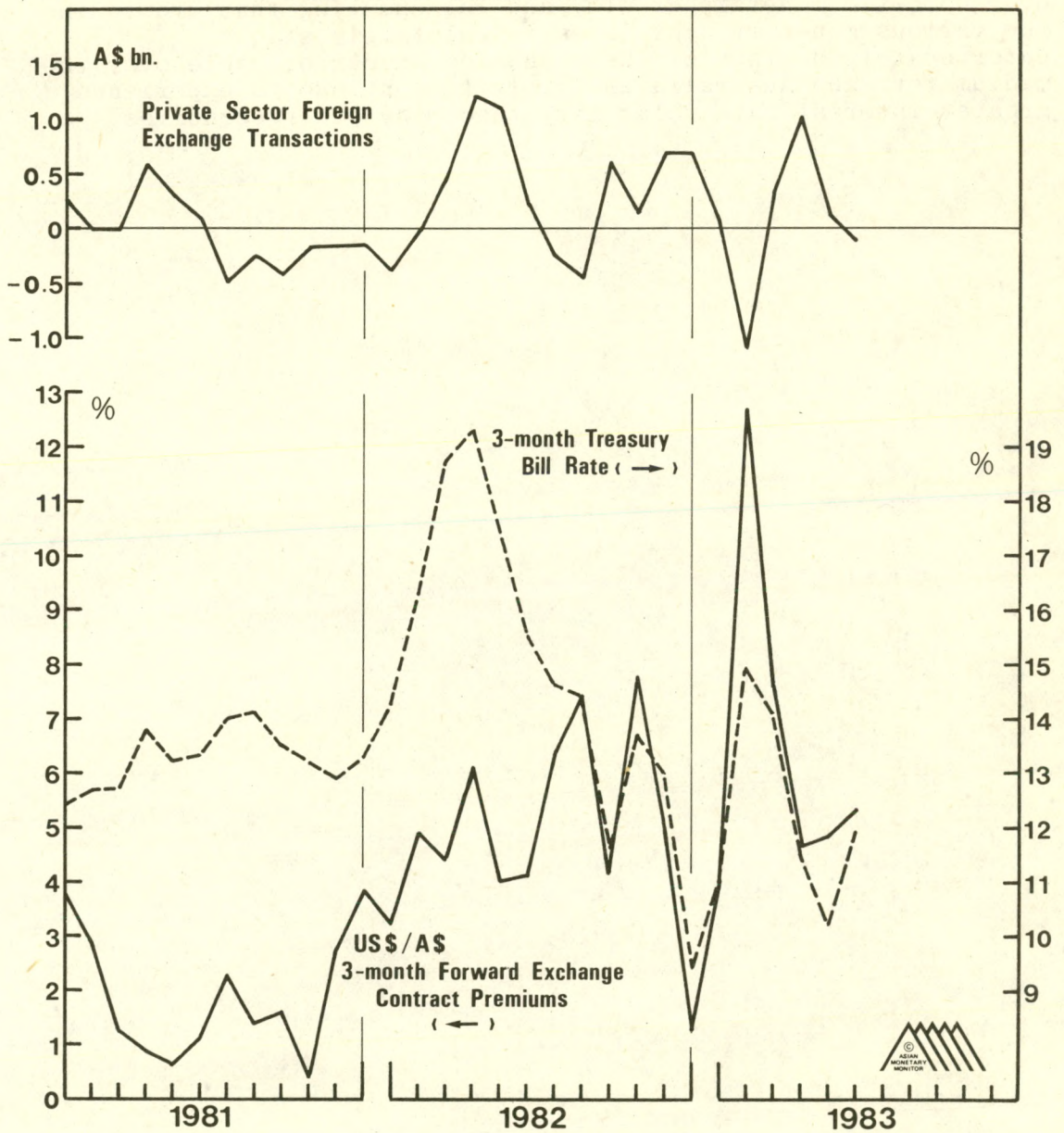
When the Australian authorities moved away from a relatively stable exchange rate regime, they did not undertake to improve their direct control over the growth of the domestic monetary aggregates. Instead the authorities appear to have undertaken adjustments to the external value of the Australian dollar in an attempt to achieve certain domestic monetary objectives. This would appear to be a very indirect method of practising monetary policy. By frequently adjusting the spot exchange rate and forward exchange rate premiums in order to influence the overall balance of payments position and domestic monetary growth, the Reserve Bank have effectively added at least one more problem to the difficult task of monetary control. For, in deciding upon an appropriate growth rate for the monetary base the Reserve Bank must not only make an attempt to assess banks' portfolio preferences between reserves and deposits, and the public's preferences between deposits and cash currency, but also local and foreign institutions desired mix of Australian and non Australian dollar assets. This policy has understandably created greater instability in short term money growth and increased variability in local interest rates.

A further source of interest rate volatility during the past year and a half is that it appears that the Reserve Bank's adjustments to the Australian dollar have been undertaken to meet changing domestic objectives over the period. Throughout 1982 it is likely (see AMM Vol. 7 No. 4) that the Reserve Bank's concern, in depreciating the Australian dollar, was to reduce short term domestic interest rates. Since the devaluation, in March this year, this policy appears to have been changed and the Australian dollar has been appreciated against its Trade Weighted Exchange Rate Index in order to provide a degree of restraint against excessive monetary growth. This apparent, unannounced, reversal in policy has exacerbated interest rate volatility in Australia.

- - - - -
There is also an unofficial Hedge Market where both capital and trade account transactions may be covered forward and where Australian banks may act as principals. In recent years this market has grown substantially and may ultimately undermine the Reserve Bank's ability to 'set' forward exchange rate premiums.

Australia : Chart 4

Treasury Bill Yields, Forward Exchange Premiums And Private Sector External Transactions



This increase in interest rate volatility will persist until either the Australian authorities revert to a more closely pegged exchange rate system or until the Reserve Bank is prepared to take greater responsibility for direct control over domestic monetary growth; and for ensuring that growth in the various monetary aggregates is relatively stable. Unfortunately neither of these changes appear probable over the medium term and Australia is likely to continue to experience greater interest rate volatility than many other economies.

HONG KONG

HOW TO RESCUE THE HK\$: THREE PRACTICAL PROPOSALS*

INTRODUCTION

A previous issue of AMM showed that each of Hong Kong's monetary instruments suffered from serious defects from a monetary control point of view and that, given present arrangements, none of the four monetary instruments could be expected effectively to permit the authorities either to control the money supply or to defend the exchange rate. We also argued that these defects in the monetary system were to a large extent responsible for the wide amplitude in Hong Kong's business cycle fluctuations, and the persistent weakness of the Hong Kong dollar in the past four years. We went on to say that the key to moderating the boom-and-bust cycle in the future and the key to rescuing the currency was in correcting the flaws in the monetary system rather than in tightening up prudential controls on banks and DTC's. In this article we explain the practical steps necessary to implement our proposals to control the money supply or manage the exchange rate.

THE NEED FOR MONETARY CONTROL

Why is it so important that the authorities should have some workable system of monetary control?

First, there is the empirical fact that the ups and downs in Hong Kong's business cycle have been closely linked to accelerations and decelerations in money and credit. In our view, by mitigating the tendency of bankers to oscillate between exuberant lending sprees which produce faster money growth and hence inflation, and bouts of extreme caution which restrict bank credit and money, and hence intensify recession, the authorities would go a long way to stabilising the Hong Kong economy.

Second, there is the irrefutable fact that under present monetary arrangements the authorities have been powerless to prevent the persistent depreciation of the Hong Kong dollar. The precise mechanics of this impotence were explained in AMM Vol. 5 No. 4 (July-August 1981) pp. 26-30 and repeated in AMM Vol. 6 No. 6 (Nov.-Dec. 1982) pp. 29-33. However, if anybody was not completely convinced by that theoretical demonstration then the pathetic collapse of the Hong Kong currency in recent months despite repeated attempts by the authorities to shore it up ought at least to prompt questions about the workings of current monetary system. We see no reason why the Hong Kong dollar should not be able to remain firm, even in the face of widespread uncertainty over Hong Kong's future after 1997, provided a sensible and workable system of monetary control is adopted. Under present arrangements, however, we see no prospect of the authorities or the HKAB**cartel being able to stop the slide for long. Unless some serious steps are taken towards monetary reform it is entirely conceivable that the

* The author is indebted to Max Fry for penetrating comments on the first draft of this paper.

** The Hong Kong Association of Banks

Hong Kong dollar will continue to slide inexorably downwards. This would be a disaster for Hong Kong, leading first to widespread social unrest as prices for imported food and fuel increase again and again, and could ultimately climax in a massive flight from the local currency.

Third, there is a more basic point of principle. Most people would agree that two of the fundamental springs of success of the Hong Kong economy are the existence of the rule of law and the minimal degree of government intervention in commercial activity. One important element of the rule of law is the equality of all individuals before the law or, to put it the other way, the lack of any class or classes which are peculiarly favoured by the law. Another basic element of the rule of law is the sanctity of contract, which implies a legal sanction to enforce contracts. The role of government in enforcing the rule of law is to provide a framework within which individuals can live their lives in whatever manner they choose provided their activity does not cause harm or damage to others.

Since money is the medium of exchange in which all contracts are expressed, it behoves a government which adheres to the principles of the rule of law to provide a framework which preserves the value of the medium of exchange. As we have argued consistently in many previous issues of AMM, the value of Hong Kong's money can only be preserved through the provision of a sensible monetary framework which ensures that, over time, the real value of the Hong Kong dollar is preserved.

Events over the past two or three years on the exchange rate front and events in the local money markets this summer have cast serious doubt on the ability of Hong Kong's present monetary system to preserve the value of the Hong Kong dollar, and it is high time in our view the authorities took a proper grip of the situation. It is no use protesting that regulating the value of the Hong Kong dollar or controlling the quantity of Hong Kong dollar money supply would be inimical to "positive non-interventionism". That argument is plainly nonsense since throughout the period 1935-1974 the value of the Hong Kong dollar was fixed, and yet there was, except in the war years, a greater degree of laissez-faire than there is today.

The fact is that a method of monetary control does exist which is entirely compatible with a stable value of the currency (in real terms) and the continuation of laissez-faire or positive non-interventionism in every other respect. In addition, this scheme of monetary control is largely consistent with existing institutional arrangements (the issue of banknotes by private banks, the absence of foreign exchange controls, the 3-tier banking structure etc.) and requires zero government intervention in the foreign exchange market.

Clearly government has to act or make changes to the present monetary system to the extent necessary to bring about monetary control, but we believe this could be achieved at minimal cost (in terms of manpower or financial resources) while bringing significant long term benefits to the economy. Therefore, under one of the alternative schemes which we propose, no 'intervention' (i.e. active purchases and sales of foreign exchange in the commercial markets to fix the HK\$ exchange rate) would be required. In other words, monetary control is quite feasible without 'intervention'.

Accepting the view that some form of monetary control is desirable (and in our opinion almost any form of control would be better than the present arrangements), the question is how to achieve control of the money supply or control of the exchange rate with minimum disruption to the famous flexibility and adaptability of Hong Kong's free market economy.

It goes without saying that any proposals for reform of the Hong Kong monetary system must be based on a complete and accurate diagnosis of what is wrong with the present system, and such proposals must correct those errors without a unacceptable degree of disruption to existing institutions. In this spirit we present our two basic alternative solutions, one of which has two possible variants, giving three possible schemes. There are some further subvariants of each scheme, but we do not consider these in detail. We also show again why the interest rate mechanism, which is the focal point of current monetary control arrangements, is a fundamentally unsound fulcrum on which to base any long term solution to Hong Kong's financial problems (Appendix 1). Finally we show why certain proposals to tighten up liquid asset requirements put forward by some banks and individuals in Hong Kong would not achieve their purported aims (Appendix 2).

DIAGNOSIS OF THE LACK OF CONTROL IN CURRENT ARRANGEMENTS

The essence of the lack of monetary control in Hong Kong's financial system lies in the fact that the Exchange Fund neither controls the quantity of base money nor guarantees its convertibility in terms of foreign currency at any specified price. Yet in all other countries of the world, so far as we know, the monetary authority performs one of these functions, either regulating the size of the monetary base (with a view to controlling the aggregate money supply), or setting the price of its currency in terms of foreign exchange. It is true that authorities elsewhere have vacillated between different policy instruments and objectives - switching between quantitative targets, exchange rates and interest rates according to shifts in the political or economic climate - so that performance has generally not matched intentions. But that does not deny the ability of the authority to determine the price of each unit of the monetary base or the quantity of base money, should they choose to do so. In Hong Kong, however, the authorities have chosen - perhaps unwittingly - not to determine either since the early 1970s. How did this come about?

CONSOLIDATED BALANCE SHEETS FOR THE CURRENT HONG KONG MONETARY SYSTEM (SEPT. 1983)

Assets	EXCHANGE FUND	Liabilities
Foreign Exchange Assets		Certificates of Indebtedness
HK\$ Deposits at Banks		Coins Issued
- - - - -	- - - - -	E.F. Borrowings from Banks
HK Government Balances		Debt Certificates
Others		Net Worth

LICENSED BANKS	
Certificates of Indebtedness	Notes Issued
- - - - -	- - - - -
HK\$ Notes and Coin	HK\$ Deposits of Public
HK\$ Loans and Investments	HK\$ Deposits of Exchange Fund/Govt.
HK\$ Interbank Balances	HK\$ Interbank Borrowings
- - - - -	- - - - -
Fx Notes and Coin	Fx Deposits of Public
Fx Loans and Investments	Fx Interbank Borrowings
Fx Interbank Balances	
- - - - -	- - - - -
Others	Net Worth

Note: The notional accounts of the Exchange Fund shown in the balance sheet above (and hereafter) reflect the two roles of the Exchange Fund as monetary authority and as fiscal agent of the government. For clear thinking and for analysis of the monetary consequences of Exchange Fund transactions it is important to separate these two functions. We have therefore divided the Exchange Fund balance sheet with a dashed line, the upper section containing items relevant to its monetary role, the lower section containing items relevant to its role as fiscal agent. The fiscal role of the Exchange Fund dates from a decision in 1977 to transfer to the Fund the Treasury's Hong Kong dollar balances (apart from working balances) against the issue of interest-bearing Debt Certificates, the bulk of the Treasury's foreign currency balances having been transferred in 1976. Between 1972 and December 1981 the Exchange Fund's HK\$ assets (and some of its foreign currency assets) therefore comprised (a) the counterpart of accumulated budgetary surpluses - i.e. the Government's fiscal reserves - and (b) HK\$ balances against the issue of CIs. When the Exchange Fund's borrowing scheme was introduced in December 1981 the HK\$ assets would have begun to reflect these transactions.

Since the authorities do not publish the Exchange Fund's accounts for public scrutiny it is not possible to put exact figures on these balance sheet items. However, that does not in the least affect the principles governing the interaction of the Exchange Fund and the banking system - i.e. the mechanisms of monetary control.

The balance sheets for the licensed banks are divided into four sections: (i) the note-issuing function of the two note-issuing banks (In a full consolidation of the authorities and the banks Certificates of Indebtedness cancel out leaving the Notes Issued as an effective liability of the monetary authorities who hold the backing for those Notes); (ii) the HK\$ domestic banking segment; (iii) a foreign currency banking segment; and (iv) residual items and net worth. The notional balance sheets for DTCs are basically the same as (ii), (iii) and (iv) except that they do not include HK\$ deposits of the Exchange Fund or Government. For simplicity we have omitted DTCs from this analysis, but statements applying to the non-note issuing banks can be taken as applying to DTCs also.

Before 1972 Hong Kong's monetary system was a classic automatic adjustment mechanism operated under a modified colonial currency board called the Exchange Fund. Instead of designing, engraving and printing the banknotes itself and issuing these colonial notes to the banks, the Exchange Fund permitted 3 private banks to continue to issue notes as they had done before 1935.* In order to issue new HK\$ banknotes the note-issuing banks had to submit sterling to the Exchange Fund in return for Certificates of Indebtedness (CIs) at a fixed rate of exchange. These are non-interest bearing certificates denominated in HK\$ permitting the bank in question to issue specified amounts of HK\$ banknotes. (See box below.) Until the early 1970s the Exchange Fund's assets would therefore have been almost entirely in sterling.**

However, in June/July 1972 the Hong Kong dollar was unhitched from sterling and pegged to the US\$. At the same time the note-issuing banks were permitted to "pay" for CIs in HK\$. To the extent that the Exchange Fund now began to hold HK\$ balances at those commercial banks against CIs it was altering the basic nature of the monetary standard from something which was equivalent to a fixed amount of foreign currency (HK\$5.65=US\$1.00 at the time) to a monetary standard which was only defined in terms of itself, even though the stated policy objective was to keep the HK\$/US\$ rate pegged at a fixed rate. Not surprisingly the authorities soon had difficulty keeping the exchange rate within the target bands.

This process culminated in the decision in November 1974 to allow the Hong Kong dollar to float freely on the foreign exchange market.

In effect the decision meant that the monetary standard was now a pure Hong Kong dollar standard. But having removed the guarantee of external convertibility at a fixed price no provisions were made at the time to control or regulate the quantity of Hong Kong dollars. Hong Kong was therefore left with a system in which neither the price nor quantity of money was controlled.

A CERTIFICATE
OF INDEBTEDNESS
(from the Exchange
Fund Ordinance,
Chapter 66 of the
Revised Edition,
Laws of Hong Kong
1971)

SCHEDULE.

[s. 4(1).]

EXCHANGE FUND ORDINANCE.

(Chapter 66).

Certificate of Indebtedness for \$

This certificate issued under the Exchange Fund Ordinance (Chapter 66) represents indebtedness of the Hong Kong Government without interest to Bank for the amount of dollars and is redeemable at any time at the option of the Financial Secretary.

This certificate may be held up to the above-mentioned amount as cover for bank notes lawfully issued in the Colony.

.....

Financial Secretary.

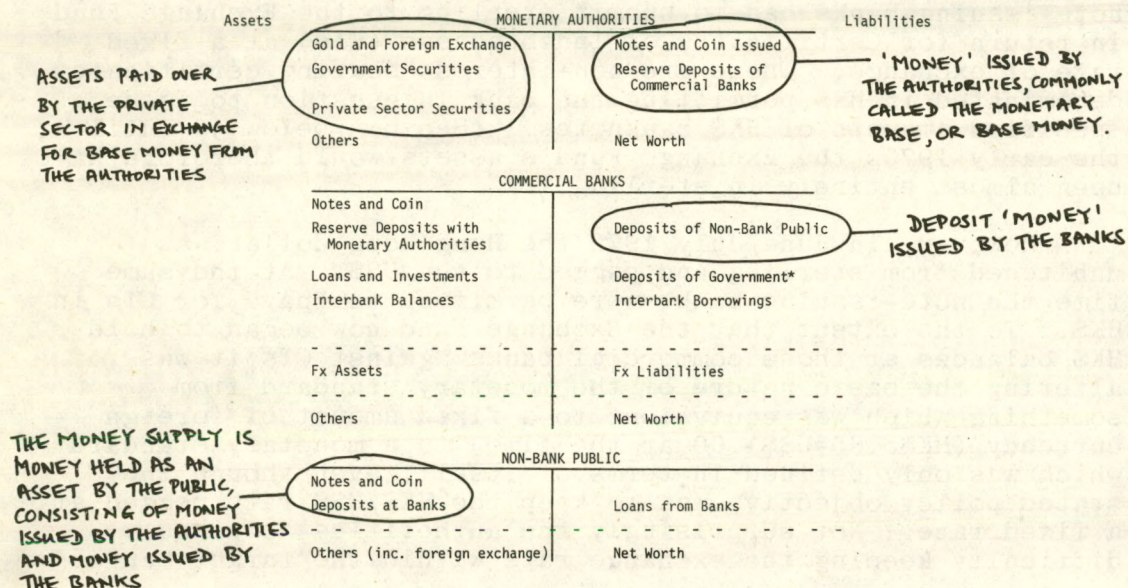
HONG KONG,

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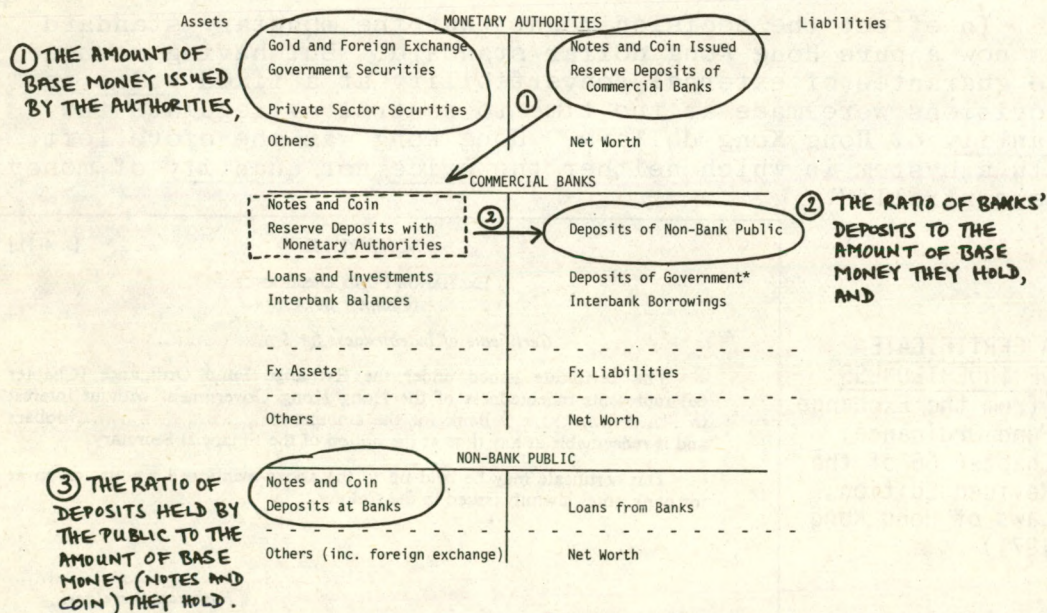
(Amended, 44 of 1936, s. 4; 12 of 1946, s. 2, and 20 of 1948, s. 4)

* The Mercantile Bank no longer issues notes, leaving two note-issuing banks.
**See Y.C. Jao, "Banking and Currency in Hong Kong", Macmillan, 1974.

IN AN ORTHODOX MONETARY SYSTEM....



.... THERE ARE 3 CRUCIAL ELEMENTS OF MONETARY CONTROL



* In some countries government deposits are held at the commercial banks, in some countries at the central bank, and in others at both. To clarify the analysis they are shown here at the commercial banks, which is also the case for Hong Kong.

IN THE HONG KONG MONETARY SYSTEM ...

Assets	EXCHANGE FUND	Liabilities
ASSETS PAID OVER BY THE PRIVATE SECTOR (IN THE PAST) IN EXCHANGE FOR BASE MONEY FROM THE AUTHORITIES	Foreign Exchange Assets HK\$ Deposits at Banks HK Government Balances Others	'MONEY' ISSUED BY THE AUTHORITIES, PROPERLY CALLED THE MONETARY BASE, OR BASE MONEY. Certificates of Indebtedness Coins Issued E.F. Borrowings from Banks Debt Certificates Net Worth
BOOK ENTRIES BY THE NOTE-ISSUING BANKS WHICH THE AUTHORITIES ACCEPT AS "PAYMENT" FOR CIs OR THE PERMITS TO PRINT BANKNOTES	LICENSED BANKS Certificates of Indebtedness HK\$ Notes and Coin HK\$ Loans and Investments HK\$ Interbank Balances Fx Notes and Coin Fx Loans and Investments Fx Interbank Balances Others	DEPOSIT 'MONEY' ISSUED BY THE BANKS. DEPOSIT MONEY ISSUED BY THE BANKS TO THE EXCHANGE FUND FOR CIs (ALSO INCLUDES FISCAL BALANCES) Notes Issued HK\$ Deposits of Public HK\$ Deposits of Exchange Fund/Govt. HK\$ Interbank Borrowings Fx Deposits of Public Fx Interbank Borrowings Net Worth
MONEY HELD AS AN ASSET BY THE PUBLIC CONSISTS OF BOTH BANKNOTES (EQUIVALENT TO CIs ISSUED BY THE AUTHORITIES) AND DEPOSITS ISSUED BY THE BANKS.	NON-BANK PUBLIC HK\$ Notes and Coin HK\$ Deposits at Banks Others (inc. foreign exchange)	Loans from Banks Net Worth

....TWO ELEMENTS OF MONETARY CONTROL HAVE MAJOR DEFECTS

Assets	EXCHANGE FUND	Liabilities																						
① NEITHER THE PRICE NOR THE QUANTITY OF BASE MONEY IS CONTROLLED IN ANY WAY. THE PRICE OF THE HONG KONG DOLLAR IS NO LONGER FIXED IN FOREIGN CURRENCY TERMS; IT IS ONLY FIXED IN TERMS OF ITSELF. NOWADAYS ONE DOLLAR OF BANK MONEY (DEPOSITS) BUYS ONE DOLLAR OF BASE MONEY (CIs).	<table border="1"> <tr> <td>Foreign Exchange Assets</td> <td>① Certificates of Indebtedness Coins Issued</td> </tr> <tr> <td>HK\$ Deposits at Banks</td> <td>E.F. Borrowings from Banks</td> </tr> <tr> <td>HK Government Balances</td> <td>Debt Certificates</td> </tr> <tr> <td>Others</td> <td>Net Worth</td> </tr> </table>	Foreign Exchange Assets	① Certificates of Indebtedness Coins Issued	HK\$ Deposits at Banks	E.F. Borrowings from Banks	HK Government Balances	Debt Certificates	Others	Net Worth															
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Net Worth																								

② THE HONG KONG AUTHORITIES DO NOT RELY ON THE RATIO OF BASE MONEY HELD BY THE BANKS TO THEIR DEPOSITS FOR MONETARY CONTROL. INSTEAD, HONG KONG HAS A SYSTEM OF SPECIFIED LIQUID ASSETS FOR PRUDENTIAL PURPOSES, UNDER WHICH EVERY ITEM IN THE DASHED LINE BOXES CONTAINS ELIGIBLE ASSETS WHICH CAN SATISFY THE LIQUIDITY REQUIREMENTS. CONSEQUENTLY IT IS RELATIVELY EASY FOR BANKS TO MEET THE LIQUIDITY REQUIREMENTS, BUT THESE SPECIFIED LIQUID ASSET RATIOS DO NOT PROVIDE A MECHANISM FOR MONETARY CONTROL.

One problem in sorting out the current Hong Kong monetary system is the curious arrangement whereby the Exchange Fund issues base money (Certificates of Indebtedness) in exchange for commercial bank liabilities (Exchange Fund deposits at the note-issuing banks) - which are another form of money. In other words, in Hong Kong base money is issued by the authorities in exchange for deposit money issued by the banks. In one sense this problem is perhaps more illusory than real. For, although in other orthodox monetary systems, by contrast, the authorities issue 'base money' (notes, coin, or reserve deposits) against the purchase of assets of the commercial banks, such new issues of base money enable the banks to create more loans and deposits. Thus the difference between the 'new' Exchange Fund deposit and a deposit generated by a loan is no more than equivalent to the difference between a primary deposit and a derivative deposit.

In another sense, however, the fact that the Exchange Fund holds domestic currency deposits with commercial banks - in its monetary capacity as opposed to its role as fiscal agent for the government - is disastrous because it undermines the potential for multiple expansion or multiple contraction effects from transactions between the authorities and the banks. If increases or decreases in Exchange Fund balances at the banks encouraged or discouraged bank credit creation in any permanent way (i.e. had some permanent effect on the monetary multiplier) this might provide some offset to the decision not to control the base. But both statistical evidence (on the stability of the monetary multiplier) and casual market observation (on the short-lived effectiveness of Exchange Fund intervention in the domestic money markets or the foreign exchange market) suggest there is no such effect.

The contrast between the Hong Kong system and other systems is illustrated by the notional balance sheets on pp.16-17.

Type of Monetary Standard	Operating Rule of the Monetary Authority	Choice of Mechanism	AMM Proposal
A pure Hong Kong dollar standard	To determine the quantity of base money	Discretionary	1
		Automatic	-
A foreign currency exchange standard	To determine the price of base money	Discretionary	2A
		Automatic	2B

The three schemes tabulated above and presented on the following pages derive from the view that the monetary authority can only determine either the quantity of base money or the price of base money. In both cases there is the option to adopt either a discretionary mechanism or an automatic mechanism. This gives four possible approaches to reforming the monetary system. For various reasons we omit consideration of what would be 1B (equivalent to a pure commodity standard), leaving three possible options for Hong Kong's monetary standard.

PROPOSED SCHEME 1

Assets	EXCHANGE FUND	Liabilities
Foreign Exchange Assets		Certificates of Indebtedness
HK\$-denominated paper		Coins Issued
- - - - -		'Special' or Reserve Deposits of Banks
HK Government Balances		Debt Certificates
Others		Net Worth
LICENSED BANKS		
Certificates of Indebtedness		Notes Issued
- - - - -		- - - - -
HK\$ Notes and Coin		HK\$ Deposits of Public
HK\$ 'Special' or Reserve Deposits at E.F.		HK\$ Deposits of Government
HK\$ Loans and Investments		
HK\$ Interbank Balances		HK\$ Interbank Borrowings
- - - - -		- - - - -
Fx Notes and Coin		Fx Deposits of Public
Fx Loans and Investments		
Fx Interbank Balances		Fx Interbank Borrowings
- - - - -		- - - - -
Others		Net Worth

SCHEME 1: TO CONTROL THE MONEY SUPPLY

A fundamental flaw in Hong Kong's monetary system today is that the Exchange Fund does not control the quantity of base money because it issues Certificates of Indebtedness (equivalent to banknotes) passively on demand.

To eliminate the passive element in the lack of control the Exchange Fund could purchase either HK\$ commercial paper or HK\$-denominated bonds or foreign exchange from banks or brokers, crediting the settling banks with the proceeds in HK\$ in newly-constituted reserve accounts at the Exchange Fund. The note-issuing banks would be able to draw on these accounts to obtain notes from the note-issuing banks (in exactly the same way as they draw today on their clearing accounts with the note issuers to obtain notes). This arrangement would mean that notes, CIs and reserve deposits were in effect interchangeable - a homogeneous form of base money.

This would immediately have three effects:

- (i) it would mean that each participating bank would hold some combination of (a) reserve deposits at the Exchange Fund and (b) notes (equivalent to CIs issued by the Exchange Fund),
- (ii) it would give the Exchange Fund direct control over the joint total of CIs (i.e. notes) and bank reserves, i.e. total base money, and
- (iii) it would provide the Exchange Fund with the means to control the money supply (and hence liquidity or money market interest rates in the short term) on a discretionary basis.

If the Exchange Fund were now to sell, say, HK\$ commercial paper via a broker, the broker would have to write a cheque in favour of the Exchange Fund which would be settled not by crediting an Exchange Fund account at a bank but by debiting the account of the settling bank at the Exchange Fund, thus reducing its reserves and obliging that bank either to lend less or to bid for more reserve deposits. Both sets of actions - the sale of the commercial paper and the reaction of the banks - will tend to push up interest rates and thus tighten the credit markets which in turn would reduce the money supply.

The exact extent of the impact of this monetary tightening operation will depend upon (i) the size of the selling operation by the Exchange Fund, i.e. the change in the base, (ii) the amount by which banks have to reduce their lending and hence their deposits in order to maintain a specified or desired ratio of reserves to deposits, and (iii) the amount by which the non-bank public have to adjust their holdings of deposits and currency to restore their desired ratio of deposits to currency.

While it is possible to conceive of this scheme only being operated with the two note-issuing banks it would clearly be desirable if all banks were to participate. This is because with all banks participating, following any change in the total quantity of reserves or base money by the Exchange Fund, market forces would operate evenly on all banks, transmitting the authorities' desire to tighten or ease money market conditions uniformly throughout the system. If the authorities were to operate only via the note-issuing banks this would give those banks the unparalleled advantage of having exclusive access to or knowledge of the authorities' intentions and this would enable them to position themselves in the market accordingly. This would be highly prejudicial to the development of properly competitive financial markets, and would no doubt soon lead to widespread discontent among the less privileged banks. Often in Hong Kong such banks are reluctant to express their discontent too openly for fear of discriminatory treatment or for fear of jeopardising their current status. This is obviously a thoroughly unhealthy situation and is not conducive to an evenly competitive banking environment. Nevertheless it is currently tolerated or at least accepted as one of the costs of doing business in Hong Kong.

Some related issues: (1) Clearing Arrangements If all banks were to participate in the scheme it would soon become apparent that the existing clearing arrangements with the note-issuing banks were somewhat superfluous. At present most banks in Hong Kong maintain clearing accounts with one of the two note-issuing banks. Since under Scheme 1 all banks would maintain accounts at the Exchange Fund it would be quite natural for banks to wish to transfer their clearing accounts to their newly constituted accounts at the Exchange Fund, and these would soon become an integral part of the interbank market as banks who were low on reserves bid for funds from those who were flush with reserves.

(2) Would Reserve Requirements be Necessary? In many countries where banks hold reserve deposits with the central bank there are legal provisions or rules requiring banks to maintain ratios of these deposits to their non-bank deposit liabilities in domestic currency. But are these minimum ratios a necessary condition for monetary control? Some quite simple algebra shows that control of the money supply can be achieved without required reserves, provided the base is controlled.

Let C = currency held by the public
 D = deposits held by the public
 R = vault cash plus licensed bank deposits with the Exchange Fund
 M = money supply
 B = monetary base

$$\begin{aligned} \text{Then } M &= C + D & (1) \\ \text{and } B &= C + R & (2) \end{aligned}$$

Now divide (1) by (2):

$$\frac{M}{B} = \frac{C + D}{C + R} = \frac{C/D + 1}{C/D + R/D} \quad (3)$$

$$\text{Hence } M = B \cdot \left(\frac{C/D + 1}{C/D + R/D} \right) \quad (4)$$

$$\text{If } R = 0, \text{ then } M = B \cdot \left(\frac{C/D + 1}{C/D} \right) \quad (5)$$

Even if banks held zero reserves (which is inconceivable since they must hold some vault cash to meet customers' needs), the money supply is still some determinate multiple of the base.

(3) The Exchange Fund as Lender of Last Resort Today in Hong Kong the two note issuing banks are effectively the lenders of last resort, partly by reason of their dominant size in the market, but also because the authorities have not previously acted in a banking capacity in the sense of issuing deposits to banks and others. However, under Scheme 1 the Exchange Fund could act as lender of last resort insofar as it could always create new reserves by purchasing the assets (HK\$ instruments or foreign currency) of any bank in distress and crediting the

accounts of that bank at the Exchange Fund in HK\$. There should be no need to operate a special discount facility, any more than the Hong Kong and Shanghai Bank does now. But obviously the Exchange Fund would stand by to provide 'liquidity' (i.e. reserves) in any emergency, just as private banks do today.

(4) Transition Arrangements Whenever this type of scheme is proposed there are some who protest that official purchases of foreign exchange (or HK\$-denominated instruments) would somehow weaken the HK\$. This objection seems groundless to us because in the initial stages of setting up the scheme the authorities would not be selling HK\$ on the open market; they would be merely crediting the newly created reserve accounts of the banks at the Exchange Fund with new HK\$. The transactions could be conducted at the market opening at an average of the previous day's rates or at a rate specified by the Exchange Fund which would soon become a guiding rate for the rest of the market. These HK\$ credits to banks would not constitute an increase in the HK\$ money supply because these accounts are not included in the money supply.

(5) The Attitude of the Chinese Banks There are some who maintain that the mainland Chinese banks in Hong Kong would never accede to join such a scheme. This seems unlikely in view of the fact that the Bank of China is already subject to inspection by the Commissioner of Banking in respect of its compliance with the Banking Ordinance. Furthermore China has a very real interest in Hong Kong's financial stability and the strength of the Hong Kong dollar since as much as one quarter or one third of its foreign exchange earnings derive from Hong Kong.

SCHEME 2A: TO MANAGE THE EXCHANGE RATE (WITH INTERVENTION)

Another fundamental flaw in the present Hong Kong monetary system is that intervention operations in the foreign exchange market by the Exchange Fund are not effective in determining the price of the HK\$. This is because intervention in the foreign exchange market does not affect the quantity of base money in the Hong Kong banking system. Consequently there is no tightening or easing of the domestic money markets in the direction desired by the authorities since the size of banks' balance sheets remain essentially unaltered by official intervention operations. (See AMM Vol. 6 No. 6 pp. 29-33.)

To overcome this problem the authorities could set up Scheme 2A which is a variant of the arrangements under Scheme 1, with the difference that instead of selling or purchasing both foreign exchange and HK\$-denominated instruments the Exchange Fund would restrict its operations to the foreign exchange market. Thus the monetary assets of the Exchange Fund - aside from the strictly fiscal balances of the government - would consist of foreign currency assets only. (This refers only to the part of the Exchange Fund balance sheet above the dashed line on p. 23; see footnote on p. 14.)

PROPOSED SCHEME 2A

Assets	EXCHANGE FUND	Liabilities
Foreign Exchange Assets		Certificates of Indebtedness Coin Issued 'Special' or Reserve Deposits of Banks
- - - - -		- - - - -
HK\$ Government Balances		Debt Certificates
Others		Net Worth

LICENSED BANKS	
Certificates of Indebtedness	Notes Issued
- - - - -	- - - - -
HK\$ Notes and Coin	HK\$ Deposits of Public
HK\$ 'Special' or Reserve Deposits at E.F.	HK\$ Deposits of Government
HK\$ Loans and Investments	
HK\$ Interbank Balances	HK\$ Interbank Borrowings
- - - - -	- - - - -
Fx Notes and Coin	Fx Deposits of Public
Fx Loans and Investments	
Fx Interbank Balances	Fx Bank Borrowings
- - - - -	- - - - -
Others	Net Worth

Under Scheme 2A the Exchange Fund would always either (1) buy HK\$ against the sale of foreign exchange, or (2) sell HK\$ against the purchase of foreign exchange, with a view to keeping the exchange rate for the HK\$ at some predetermined rate or within some agreed range against one currency or against a basket of currencies.

In the first type of operation banks' reserve accounts at the Exchange Fund would be debited with the HK\$ equivalent of the amount of foreign currency sold. The reduction in banks' balances at the Exchange Fund would force them to restrict their HK\$ lending, thus slowing or reducing HK\$ deposit growth. This type of multiple contraction effect in the aftermath of local currency support (i.e. purchase) operations would automatically and immediately produce a tightening in the local money markets which would reinforce the authorities' original intervention operation.

Conversely, sales of HK\$ against purchases of foreign currency by the Exchange Fund would lead to a crediting of banks' balances at the Exchange Fund, thereby increasing total reserves and enabling banks to increase their HK\$ lending and accelerating deposit growth. This multiple expansion effect would immediately start to ease local money markets, reinforcing the authorities' original sale of Hong Kong dollars.

The beauty of such intervention operations under Scheme 2A is that foreign exchange rate movements and money market interest rate movements would both be in complementary directions, and this mutual reinforcement would virtually guarantee success for official foreign exchange intervention operations. This is in contrast to present arrangements under which the Hong Kong dollars bought in support operations are not debited to any banks' reserve accounts but are credited back to their deposits with the net result that deposits are merely transferred from the private sector to the government and there is no contractionary effect on the banking system as a whole.

It is important in the debate over the exchange rate to separate the problem of political confidence from the problem of monetary mechanics. There is little that the monetary authorities can do about the politics of the 1997 negotiations in Peking; however there is much that they can do about the monetary system in Hong Kong which would help to protect the Hong Kong dollar from persistent erosion.

Related Issues (1) - (5) Despite the difference in operating rules between Scheme 2A and Scheme 1 (i.e. the exchange rate rather than the monetary base), the comments applying to (1) clearing arrangements, (2) reserve requirements, (3) the Exchange Fund as lender of last resort, (4) transition arrangements and (5) the attitude of the Chinese banks in respect of Scheme 1 would all apply to Scheme 2A because the institutional changes implied by the adoption of either scheme are essentially the same.

Conclusion on Schemes 1 and 2A There can be little doubt that Scheme 1 would provide the technical tools necessary to control the monetary base and hence the money supply, and that Scheme 2A would provide the tools necessary to manage the HK\$ exchange rate. Clearly the introduction of these discretionary mechanisms would mark a further departure from Hong Kong's traditionally non-interventionist monetary policy, but would they be consistent with the preservation of its predominantly free market for labour, for financial and physical assets, and for goods and services?

The schemes described above are exactly the same in principle as many other central bank/fractional reserve banking systems operating in the world today. The primary objection to such systems is that they are discretionary, depending on the personal decisions of administrators, and they offer numerous temptations to the central bank or government to exceed their

proper role of providing a stable monetary framework (i.e. a currency of stable internal and external value), and to become involved in the allocation of resources.*

A second objection to these discretionary schemes is that the transformation of the Exchange Fund from a passive issuer of CIs to an active central bank regulating the growth of the monetary base would clearly involve extensive institutional changes which many concerned individuals would be most reluctant to contemplate. It is not that institutional changes are wrong in themselves, but if monetary control can be achieved without major structural changes, then so much the better.

A third objection applicable to Scheme 1 in Hong Kong's current circumstances is that even the provision of stable money growth might not be sufficient to prevent erosion of the exchange value of the Hong Kong dollar if confidence in the future were to be undermined. Under these conditions even stable money growth could be quite consistent with a falling exchange rate, rising prices and rising income velocity of circulation.

While Scheme 1 and 2A are practically feasible they imply extensive structural changes at a difficult moment in Hong Kong's history, and a degree of governmental discretion which could further diminish the operation of the free market in Hong Kong. For these reasons it would seem preferable to examine alternative arrangements.

SCHEME 2B: TO MANAGE THE EXCHANGE RATE (WITHOUT INTERVENTION)

Each of the two previous schemes essentially involves converting the Exchange Fund into a central bank, and using the new apparatus to regulate the amount of base money either as a means of influencing the money supply (Scheme 1), or as a means of managing the exchange rate of the HK\$ (Scheme 2A). Both schemes depend on the same two basic propositions: (1) that it is necessary for the authorities deliberately to control the quantity of base money in the economy, and (2) that there is some fairly well-defined relation between the amount of base money and the money supply i.e. the ability of the banking system to multiply up base money into loans and deposits.

However, suppose the authorities are humble enough to admit that they do not know exactly how much new base money they ought to supply in any year (Scheme 1), and suppose that they would prefer to avoid the task of daily intervention in the foreign exchange market to peg the price of the Hong Kong dollar (Scheme 2A). How can the monetary system be controlled now?

* See Milton Friedman, "A Program for Monetary Stability", Fordham University Press, New York 1960.

The only satisfactory answer to this question that we have been able to advance is that the authorities must devise a system for setting the exchange rate such that the rate of monetary growth is automatically related to the state of the overall balance of payments at the chosen exchange rate. Balance of payments surpluses would permit a degree of monetary expansion, while balance of payments deficits would imply some monetary contraction until the payments position returned to equilibrium.

To avoid the need for the authorities to intervene actively in the foreign exchange markets and hence to allow the amount of base money to be regulated passively it is necessary that whatever serves as base money (CIs or notes in Hong Kong) should be available in unlimited amounts at a stated price in foreign currency, and that it should be redeemable on similar terms in indefinite quantities. In technical terms, the supply curve for base money should be horizontal at some stated price in foreign currency. In other words the authorities should stand willing to supply or redeem currency (or CIs) at the stated price, thus allowing the amount of base money to expand or contract in line with the needs of the non-bank public and the banks, given the state of the overall balance of payments at the chosen exchange rate.*

The second requirement of such a system is a guarantee of convertibility or interchangeability or perfect substitutability between base money and the deposit money issued by the banks. The reason is that in this type of automatic adjustment mechanism the link between total money supply and the amount of base money is not dependent upon any required or legislated ratios; rather it depends on (a) the desired deposit-to-currency ratios of the banks and the non-bank public, and (b) the efficient operation of market forces.

(a) Determinant Ratios of the Banks and the Non-Bank Public

Both the banks and the non-bank public hold base money. Because the banks issue deposit money which the public can convert into cash on demand, they will tend (collectively) to hold some fraction of their deposit liabilities in the form of notes and coin (base money). That fraction will depend on such things as the maturity structure of their deposit liabilities (i.e. the relative sizes of their demand, time and savings deposits, and their respective convertibility into cash), the efficiency of their vault cash management operations, and the habits of payment of the community (i.e. cash vs. bank transfers, seasonal payment patterns etc.).

Provided these determinants of the amount of banks' cash currency assets relative to their deposit liabilities remain stable over time there is no reason why the link between base money held by the banks and the total volume of deposits should not behave in a quite predictable way. There will of course be seasonal fluctuations in the ratio, and there may be gradual changes over time, but we can find no valid objection to reliance on this lever as one of the keys to regulating monetary growth. (Certainly it is more dependable than interest rates!)

- - - - -

* This is the classic gold standard mechanism with the nominal money supply adjusting to international specie/payments flows at a fixed price level.

PROPOSED SCHEME 2B

Assets	EXCHANGE FUND	Liabilities
Foreign Exchange Assets		Certificates of Indebtedness Coin Issued
- - - - -		- - - - -
HK Government Balances		Debt Certificates
Others		Net Worth

LICENSED BANKS	
Certificates of Indebtedness	Notes Issued
- - - - -	- - - - -
HK\$ Notes and Coin	HK\$ Deposits of Public
HK\$ Loans and Investments	HK\$ Deposits of Government
HK\$ Interbank Balances	HK\$ Interbank Borrowings
- - - - -	- - - - -
Fx Notes and Coin	Fx Deposits of Public
Fx Loans and Investments	Fx Bank Borrowings
Fx Interbank Balances	
- - - - -	- - - - -
Others	Net Worth

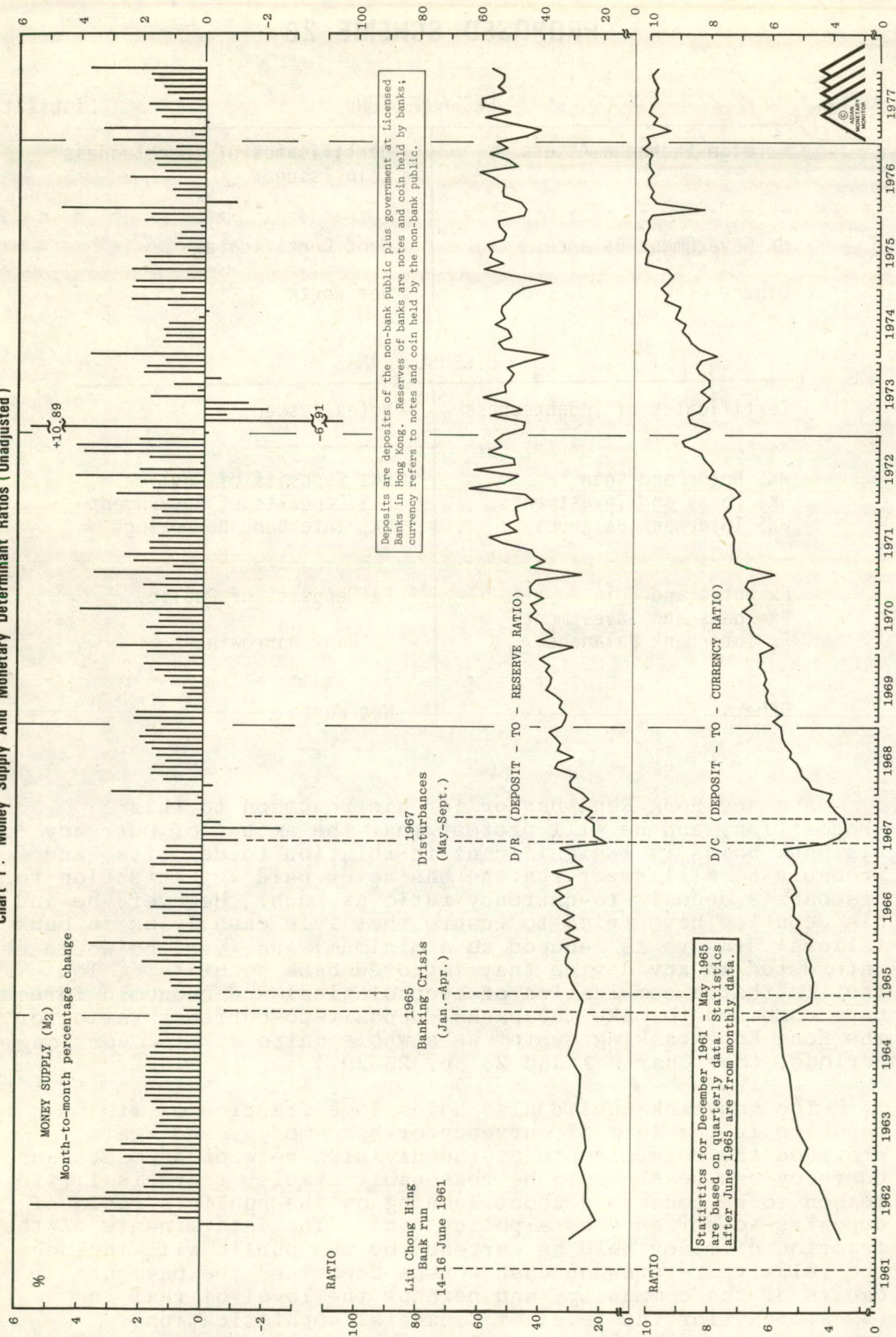
Ask any Hong Kong banker for his reaction to this proposition, and he will protest that the amount of currency his bank holds is insignificant in relation to deposits, and probably he will swear that he has never paid any attention to his bank's deposit-to-currency ratio as such. However, he and his deputies have tried to ensure that idle cash lying in bank tellers' drawers is reduced to a minimum, and, yes, he would be interested in any device that improved bank security... The fact is that a combination of technological and economic forces have combined to make the banks' deposit-to-currency ratio for the Hong Kong banking system as a whole quite stable over long periods. (See Charts 1 and 2, pp. 28-29.)

The non-bank public also holds some fraction of its deposits in the form of currency or base money, and again, provided the determinants of the division between deposits and currency can be shown to be reasonably stable, there is little reason to be concerned about leaning on the public's ratio of deposits-to-currency as a policy tool. The determinants of the fraction of money held as currency by the public will include the relative returns on cash versus deposits, the payment habits of the community, and perhaps the level of real income (as a proxy for the level of financial sophistication).

(cont'd on p. 30)

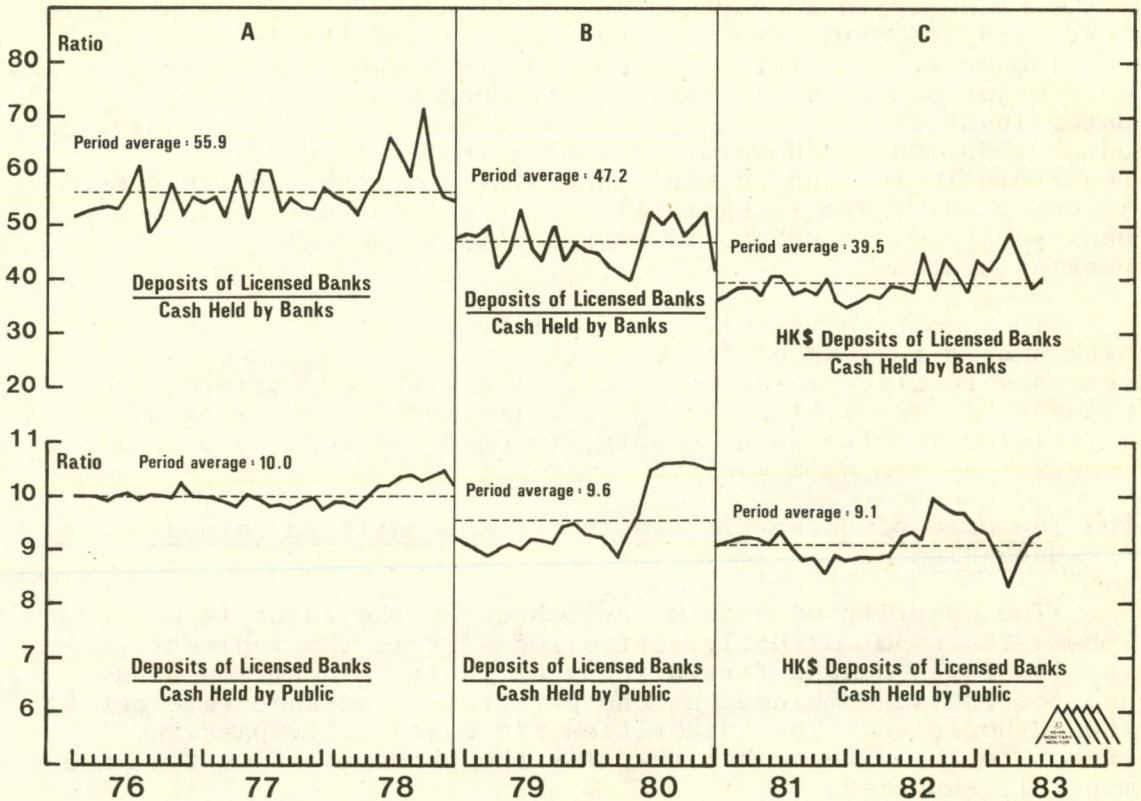
HONG KONG

Chart 1: Money Supply And Monetary Determinant Ratios (Unadjusted)



HONG KONG

Chart 2: Monetary Determinant Ratios (Adjusted)



Notes: (1) The three panels (A, B, C) in the chart reflect changes in the collection of monetary data in Hong Kong in recent years. Panel A records data collected by the Commissioner of Banking showing gross deposits at licensed banks in Hong Kong including foreign currency deposits and deposits of DTCs. In 1979 a slight improvement in data collection occurred with the separation of DTC deposits from those of the public (Panel B), but foreign currency deposits were still included. In 1981 with the passage of the Monetary Statistics Ordinance a further improvement was made (Panel C) with the separation of HK\$ deposits from foreign currency deposits. Unfortunately from an analytical point of view Hong Kong's data still do not separate government and Exchange Fund deposits from deposits of the non-bank public.

(2) Data are collected for the last banking day of each month, and consequently there appear to be random disturbances due to differing cash withdrawal patterns on different days of the week.

(3) Another major seasonal problem is Chinese New Year. This is an annual public holiday in the January-March period set according to the lunar calendar, when substantial cash withdrawals are made by the Hong Kong population. Although the actual disturbances the festival produces may be assumed to be regular, as the banks first prepare cash currency inventories, then pay them out, and finally take the cash back in again and redeem the notes, the statistical recording of these events by the official banking data is quite random. In some years data are heavily affected by the incidence of Chinese New Year at month-end, while in other years the data may not be affected at all, while in still other years the official data may capture only the start of the process or only the tail-end of it.

The data in Chart 1 are unadjusted. Accordingly most of the downward spikes in the January-March period of any year are due to Chinese New Year.

The data in Chart 2 have been "adjusted for Chinese New Year" by a simple statistical smoothing technique, but other seasonal adjustments have not been attempted.

Confidence will also play a significant role: whenever the Hong Kong public has lost confidence in the banks or DTCs, the ratio of deposits to currency has fallen sharply as people have converted deposits into currency and awaited the return of confidence in the system. Such bank runs (Chart 1) have been the only major source of instability in Hong Kong's monetary determinant ratios in the past two decades for which we have data (1962-1983). However, assuming that the prudential requirements for and careful supervision of the banking system is enforced, there is again little reason to fear that the non-bank public would behave in such a way as to destabilise the banking system.

To summarise: stable behaviour by the banks and the non-bank public in respect of their holdings of base money or currency relative to deposits combined with appropriate prudential supervision should be quite sufficient, without legislated reserve requirements, to ensure stability of the monetary system as a whole.

(b) The Role of Market Forces in the Automatic Adjustment Mechanism

The quantity of base money issued by the authorities in Scheme 2B is not directly controlled - it is the indirect result of the demand for currency or vault cash by the banks and the public combined, at the particular exchange rate set by the authorities. The authorities are essentially passive, except to the extent that they fix the price at which the base money is supplied.

Assuming the authorities will only issue base money to banks and will not deal with members of the non-bank public, banks will have a choice on a day-to-day basis between extending more loans (or making investments) in HK\$, or holding more HK\$ cash currency. Clearly they will prefer to make more loans so long as they can satisfy any liquidity requirements, since these are earning assets as opposed to currency which is a non-earning asset. As the quantity of loans (and hence deposits) increases, spending in Hong Kong will increase and the balance of payments will deteriorate. This will show up in the commercial T.T. market as a weakening of the HK\$ spot rate relative to the Exchange Fund's offered rate for CIs.

Suppose the Exchange Fund rate (stated in US\$ for argument's sake) is HK\$7.50 and the T.T. rate falls to HK\$7.55. The banks now have a choice: either they may sell HK\$ to the Exchange Fund at HK\$7.50 and obtain US\$, or they can sell HK\$ in the commercial market at the less favourable HK\$7.55 rate.

At some stage there will be a clear incentive for banks to sell cash or CIs back to the Exchange Fund at the Exchange Fund's rate, rather than make new loans. These redemptions of HK\$ base money at the Exchange Fund will cause a contraction of the total quantity of base money, and the banks as a whole will feel under pressure to slow down their lending. If they slow

their lending under conditions where the demand for credit is strong, clearly this will lead to upward pressure on interest rates in Hong Kong, helping the commercial T.T. rate for HK\$ to move back towards the Exchange Fund's offered rate. The rise in interest rates in turn will induce a decline in the demand for money balances consistent with the monetary contraction which stems from reduced credit demand at these higher interest rates. In short, as long as the overall balance of payments was negative, pressure would be brought to bear on bank lending and the money supply until the original deficit was corrected.

Let us examine the process in reverse, i.e. in the case where the T.T. rate was stronger than the Exchange Fund's offered rate for CIs. Let the Exchange Fund rate be at HK\$7.50 again, and the T.T. be HK\$7.45. This time the banks have a choice of buying US\$ from the Exchange Fund at HK\$7.50, or obtaining US\$ at HK\$7.45 in the commercial/T.T. market. Clearly they will prefer the latter, which means that currency will not be redeemed at the Exchange Fund and no pressure will be put on bank's holdings of cash, enabling them expand their lending. Lower interest rates from the increased supply of credit will encourage an increased demand for money balances consistent with the monetary expansion. In other words, as long as the overall balance of payments was positive, there would be no pressure to restrict bank lending and the money supply until the surplus was eliminated.

The beauty of this mechanism is that it is automatic, it requires no intervention by the authorities, and it requires minimal changes in Hong Kong's present institutional structure. To minimise the spread between the Exchange Fund's offered rate and the commercial or T.T. rate, however, it would be desirable to allow market forces to operate throughout the system as freely as possible. This could easily be accomplished by permitting banks other than the note-issuers to have access to the Exchange Fund's conversion facilities. These other banks would obviously submit notes rather than CIs to the authorities, who would pay the banks foreign exchange at the same rate as that received by the note issuers. The authorities would simultaneously cancel the equivalent amount of CIs, notifying the note issuers. The authorities' holdings of notes could of course be returned to circulation whenever a note-issuing bank was willing to pay over more foreign exchange for CIs in the normal way.

In essence this mechanism (i) makes notes and CIs interchangeable, thereby making base money homogeneous, and (ii) it greatly enhances the efficiency of the arbitrage between the Exchange Fund's rate for banknotes and the commercial/T.T. rate for foreign currency in the markets. (As all first year students of economics will know, homogeneity of product and free entry to the market place are two basic conditions for perfect competition.) The greater the possibilities were for this arbitrage, the less would be the divergence between the Exchange Fund's offered rate and the commercial/T.T. rate, and the more rapid would be the adjustment of the money supply to the balance of payments and vice-versa.

What are some of the practical implications of Scheme 2B?

1. How would the foreign exchange markets operate?

Since Scheme 2B is essentially a return to the old automatic adjustment mechanism one would expect exchange rates to behave much as they did in the years before 1972, with the commercial or T.T. rates fluctuating narrowly on either side of the Exchange Fund's offered rate for CIs in line with the balance of payments. The commercial market rate for the HK\$ would be at a slight premium to the Exchange Fund's rate for CIs when the balance of payments was in surplus, and at a slight discount to the Exchange Fund's rate for CIs when the balance of payments was in deficit.

As suggested in AMM Vol. 3 No. 6 (Nov.-Dec. 1979, pp. 18-22) there would be no need for the authorities to keep the rate for CIs pegged rigidly against one currency; they could aim simply at stabilising the trade-weighted index for the HK\$, announcing their rate for CIs daily (or weekly or monthly) against one particular currency; or define the HK\$ in terms of SDRs.

2. How would the money supply and inflation behave?

Under Scheme 2B the ultimate constraint on bank credit and money supply expansion is the amount of base money held by the banks.

In the long run the money supply could only accelerate continuously if the community as a whole had sufficient foreign currency to pay over to the Exchange Fund for new CIs (or new note issues). This would only occur as long as Hong Kong was paying its way in the world (i.e. running an overall balance of payments surplus), and there would be no harm in monetary acceleration under these conditions. Conversely the money supply would only slow down continuously if the community as a whole was caught short of foreign exchange - e.g. when the domestic economy became overheated; but again there would be no harm in that. (Indeed, this was exactly what was required at the time of the 1980-81 property boom, but unfortunately the automatic adjustment mechanism had been rendered inoperative by the monetary changes of 1972-74.)

In the short run there would of course be some elasticity in the relation between the money supply and the amount of base money, but the underlying stability of the monetary determinant ratios documented in Charts 1 and 2 (pp.28-29) would ensure that this short term elasticity did not undermine longer term monetary stability.

Under Scheme 2B inflation - that is, the general or overall price level - would be indirectly controlled by the authorities' choice of exchange rate for CIs. If they wished to have a low rate of inflation they would gradually move the rate for CIs upwards against other currencies. If they wanted to have an inflation rate approximating to that of Hong Kong's main trading partners the obvious thing to do would be

to base the rate for CIs on a trade-weighted index of the Hong Kong currency. This is because in each case the inflation rate would be the outcome of whatever the money supply growth rate was at the chosen exchange rate. And the money supply in turn would reflect the balance of payments at that exchange rate, accelerating if the balance of payments was strong, decelerating if the balance of payments was weak.

3. How would interest rates behave?

As in all other economies the level of nominal interest rates in Hong Kong would be the result of two interacting channels of transmission. First, there is the domestic supply and demand for credit. In Scheme 2B the supply of bank credit is ultimately regulated by the banks' access to base money, and the Exchange Fund would indirectly control the amount of base money by setting the price for CIs. On the demand side the more stable behaviour of the money supply (at least under normal conditions) should mean greater stability for domestic demand generally, and hence for credit demand in particular.

Second, there is the influence of foreign interest rates as transmitted via the foreign exchange markets (i.e. from international trade transactions, from foreign capital markets, from interest arbitrage transactions etc., etc.). The current and expected level of the HK\$ exchange rate is obviously crucial to this set of influences, and here again the Exchange Fund would play a key role via its pricing of CIs, because, as explained above, market exchange rates could be expected to vary within quite a narrow range on either side of the Exchange Fund's rate for CIs.

In short the Exchange Fund would play a crucial part in determining the environment for interest rates through its impact on both the domestic and foreign channels of influence. Its role would be indirect (for it would not be involved directly in any of the commercial credit markets) and impartial (for it would not favour any particular interest groups), yet pervasive.

The HKAB's Interest Rate Agreement is clearly irrelevant to the operation of these mechanisms. The Agreement could continue to exist, but it would be superfluous if not counterproductive to the automatic adjustment of the money supply to the balance of payments and vice-versa at the chosen exchange rate. In time the Interest Rate Agreement would be eroded as the credit and foreign exchange markets became more efficient, and then gradually it could be dismantled without any harm to the machinery of monetary control - indeed its abolition would positively enhance the automatic adjustment mechanism.

CONCLUSION : The three schemes described in the preceding pages provide a logical and coherent package of solutions drawn from a common and consistent framework of analysis. These proposals are substantially the same as those put forward by AMM in 1979 - the only significant difference being that we have adapted the money supply control proposal there to enable the exchange rate to be managed (Scheme 2A). Our own preference among these three is for Scheme 2B not only since it requires least alteration to the present institutional structure in Hong Kong (and therefore is possibly the least politically unacceptable of the three schemes), but, more importantly, in the longer term Scheme 2B implies less intervention by the authorities in the operation of the financial system.

At the core of our analysis is the view that the internal and external anchors of monetary control were unknowingly thrown overboard in 1972-74 by decisions to change the note issue mechanism and to float the exchange rate, and those anchors have never been satisfactorily replaced. Since that time there have been several attempts at patching up the system, but none of this official tinkering was based on a sound, fundamental analysis of how the monetary system as a whole operated. As a result the 100% Liquid Asset Requirement against short-term deposits of the Exchange Fund (1979), the much vaunted 3-tier banking structure and HKAB's Interest Rate Agreement (Jan. 1981), and the official money market borrowing scheme (Dec. 1981), have all failed to correct the fundamental problems of Hong Kong's monetary system.

Until some effective action is taken based on a sound analytical framework such as that presented here, readers are advised to be highly sceptical of the ability of the authorities to do anything whatever to rescue the crumbling Hong Kong dollar. In 1981 we blew the whistle on the Hong Kong monetary system, and although the authorities heard the whistle, they failed to take effective action. How far must the Hong Kong dollar fall before a soundly-based rescue plan is put into effect?

Appendix 1

WHY INTEREST RATES ARE A BAD TOOL FOR MONETARY CONTROL

First, in Hong Kong the authorities cannot control any particular interest rate under present monetary arrangements. More importantly, neither the banks nor the authorities can determine interest rates conceived in the broad, fundamental sense of the marginal productivity of investment, the returns (pecuniary and non-pecuniary) on assets such as businesses, real estate, and durable goods, or the returns on credit instruments. Only the market can do that. Policies designed to set bank deposit or bank loan rates stem from a basic confusion between the returns from holding money and the price of credit in the "money" (i.e. credit) markets.

Second, if three month deposit interest rates are set at, say, 8%, how do we know that this is the 'right' level? And which are the 'right' interest rates to follow? With an inflation rate of 10%, 8% interest rates could be too low; but with a 5% p.a. money supply growth rate, 8% interest rates could be too high. There is no way of knowing.... If the authorities were to focus on the exchange rate and set that directly (as in Scheme 2A or 2B), rather than allow the exchange rate to be whatever happens to be the outcome of the HKAB Interest Rate Agreement, we would at least be able to predict the consequences in terms of inflation. For example, by pegging the HK\$ to the US\$, Hong Kong could expect to average the same inflation rate as in the United States over a period of a few years. By pegging to a basket of currencies Hong Kong could expect to average an inflation rate approximating to a composite of the inflation rates in those countries whose currencies comprised the basket. But pegging interest rates gives no such assurance.

Third, even in an orthodox monetary system controlling interest rates leads to instability, with monetary growth alternating between excessive rapidity (which produces inflation) and insufficiency (which brings recession). This is because, in part, controlling interest rates is a highly inefficient way of achieving the objective at hand. In the words of Milton Friedman commenting on the UK Green Paper of March 1980* on Monetary Control: "Trying to control the money supply through 'fiscal policy and interest rates' [to quote the Green Paper] is trying to control the output of one item (money) through altering the demand for it by manipulating the incomes of its users (that is the role of fiscal policy) or the prices of substitutes for it (that is the role of interest rates). A precise analogy is like trying to control the output of motor cars by altering the incomes of potential purchasers and manipulating rail and air fares. In principle, possible in both cases, but in practice highly inefficient. Far easier to control the output of motor cars by controlling the availability of a basic raw material, say steel, to manufacturers - a precise analogy to controlling the availability of base money to banks and others."**

These shortcomings apply in orthodox systems where, if the monetary base is allowed to accommodate passively, the pegging of one interest rate is at least feasible - though only in the short term. They apply *a fortiori* in Hong Kong where there is no control of the base either in terms of its price (i.e. foreign exchange value), or in terms of its quantity.

* "Monetary Control." A Consultation Paper by H.M. Treasury and the Bank of England" Cmnd. 7858, March 1980.

** Quoted in "Monetary Control in the United Kingdom" by M.J. Artis and M.K. Lewis (p. 124) 1981, Philip Allan Publishers Ltd.

Appendix 2

WHY AMENDING THE LIQUID ASSET RATIOS WILL NOT WORK

Numerous proposals have been made in recent years to improve monetary control in Hong Kong by amending the system of liquid asset ratios (S. 18 of the Banking Ordinance) in such a way as to restrict credit creation. Here we deal with the two most frequently voiced proposals, and then generalise the analysis.

(1) A Compulsory Minimum Cash Ratio

One proposal put forward by the Hong Kong and Shanghai Banking Corporation's monthly Economic Report (August 1982 p. 2) is to introduce a compulsory cash ratio for the licensed banks which would require banks to hold notes and coin equivalent to some fixed percentage (3-5%) of their deposit liabilities in HK\$. At first sight this appears similar to AMM's Scheme 2B insofar as both rely on the link between the quantity of HK\$ deposits and the quantity of base money - i.e. the multiple expansion/contraction process which is at the heart of fractional reserve banking systems - to control money growth. However, the HSBC cash ratio proposal nowhere mentions any device for limiting the cash or base money which forms the numerator of their ratio.

If the Exchange Fund were to continue to issue CIs passively and on demand against Exchange Fund deposits at the note-issuers (i.e. at virtually nil cost) as it does at present, how would the total quantity of base money behave? The note issue would swell rapidly as the demand for cash by banks rose, and bank spreads might be widened slightly to compensate for banks' need to hold more non-earning assets, but the world would go on very much as before.

Unless the authorities were simultaneously to introduce a mechanism to limit the quantity of notes or base money issued, the proposal would make no contribution to monetary control. But if the authorities were to introduce a mechanism to limit the quantity of notes or base money, a compulsory cash ratio would, in our view, almost certainly be superfluous, if not positively harmful in that it would impose an unwarranted degree of uniformity on the banks, discouraging some healthy specialisation in the banking sector.

(2) Closing the Foreign Asset Loophole for Manufacturing Liquidity

A second proposal which is often put forward is that banks should not be able to 'manufacture liquidity' by counting as specified liquid assets their gross assets at call in foreign currency with banks outside Hong Kong. This technique is felt by many to be the major loophole in Hong Kong's monetary system and the source of an unfair advantage to foreign banks. The idea behind the proposal is that by restricting the range of assets which count as liquid assets, the credit-creating capacity of banks will be reduced, and then only those banks with bona fide HK\$ liquid assets or with genuine net foreign assets will be able to expand credit in Hong Kong.

What would happen if this proposal was implemented?

Assuming banks had some leeway to set off capital against liquid assets, implementing this proposal would immediately lead to new injections of foreign capital and other fund-raising exercises necessary to show 'net' foreign assets for Hong Kong branches, and/or it would lead to a scramble for those HK\$ assets which qualified as 'liquid assets'. Suppose for a moment the Exchange Fund did not undermine the proposal by continuing passively to issue liquid assets (i.e. CIs or notes), all that would happen is that other qualifying HK\$ assets (such as foreign exchange bills, sight drafts, MTR bonds etc.) would go to a slight premium (i.e. a lower yield), encouraging private sector borrowers to issue more of these eligible credit instruments, until supply had adjusted to demand. Unless the authorities can actually control the total supply of liquid assets it is pointless to tamper with the liquidity ratios because market forces will rapidly be set in motion to create those instruments which will most easily satisfy banks' requirements.

Perhaps more important, there is no assurance that any of this would occur at all if, as one might suspect, the only effect was to reduce the aggregate liquidity ratio for the Hong Kong banking system from around 49% to nearer the minimum 25% required ratio.

Address the Fundamentals

To generalise, the basic objection to these and other similar proposals is that they do nothing to address what we have called the two fundamental flaws in Hong Kong's monetary system, namely (1) the inability of the Hong Kong authorities under present arrangements to control the supply of base money, and (2) the failure to define or treat as reserves of the banks only those assets which correspond to liabilities of the Exchange Fund. Since 1979 AMM has consistently advocated correcting these fundamental flaws in the system rather than tampering with the liquidity ratios. How far does the Hong Kong dollar have to fall before the authorities get to grips with what is fundamentally wrong?

SUMMARY OF PROPOSED SCHEMES

OBJECTIVES

REQUIREMENTS

Scheme 1

To control
the money supply

1. All Licensed Banks to establish HK\$ deposit accounts at Exchange Fund.
2. Exchange Fund to regulate the volume of these reserve deposits either
 - (a) by purchases and sales of foreign exchange, or
 - (b) by purchases and sales of HK\$ denominated instruments
 - each against credits or debits to the Licensed Banks' reserve deposit accounts at the Exchange Fund

Scheme 2A

1. All Licensed Banks to establish HK\$ deposit accounts at the Exchange Fund.
2. Exchange Fund to regulate the volume of these reserve deposits only by purchases and sales of foreign exchange against credits or debits to Licensed Banks' accounts at the Exchange Fund.

Scheme 2

To manage
the exchange rate

Scheme 2B

1. The Exchange Fund would transfer its HK\$ deposit accounts with the Licensed Banks to the Government's fiscal account. It would no longer operate such HK\$ deposit accounts in its monetary capacity.
2. The Exchange Fund would only set a price in foreign exchange for CIs and it would be willing to buy or sell an indefinite amount at that price. The Exchange Fund would only operate in the market for CIs (= banknotes); it would not intervene in the regular foreign exchange market.

IMPLICATIONS

1

1. Effectively this amounts to establishing a central bank
2. Difficult decisions need to be made on the appropriate rate of monetary growth.
3. While there need be no change in the note issuing arrangements, it would be preferable for the clearing facilities to be operated at the Exchange Fund or central bank rather than at HSBC as at present.
4. For best operation of the scheme adequate disclosure will be required on goals (monetary targets), and on operations (publication of Exchange Fund balance sheet etc.) on a regular basis.

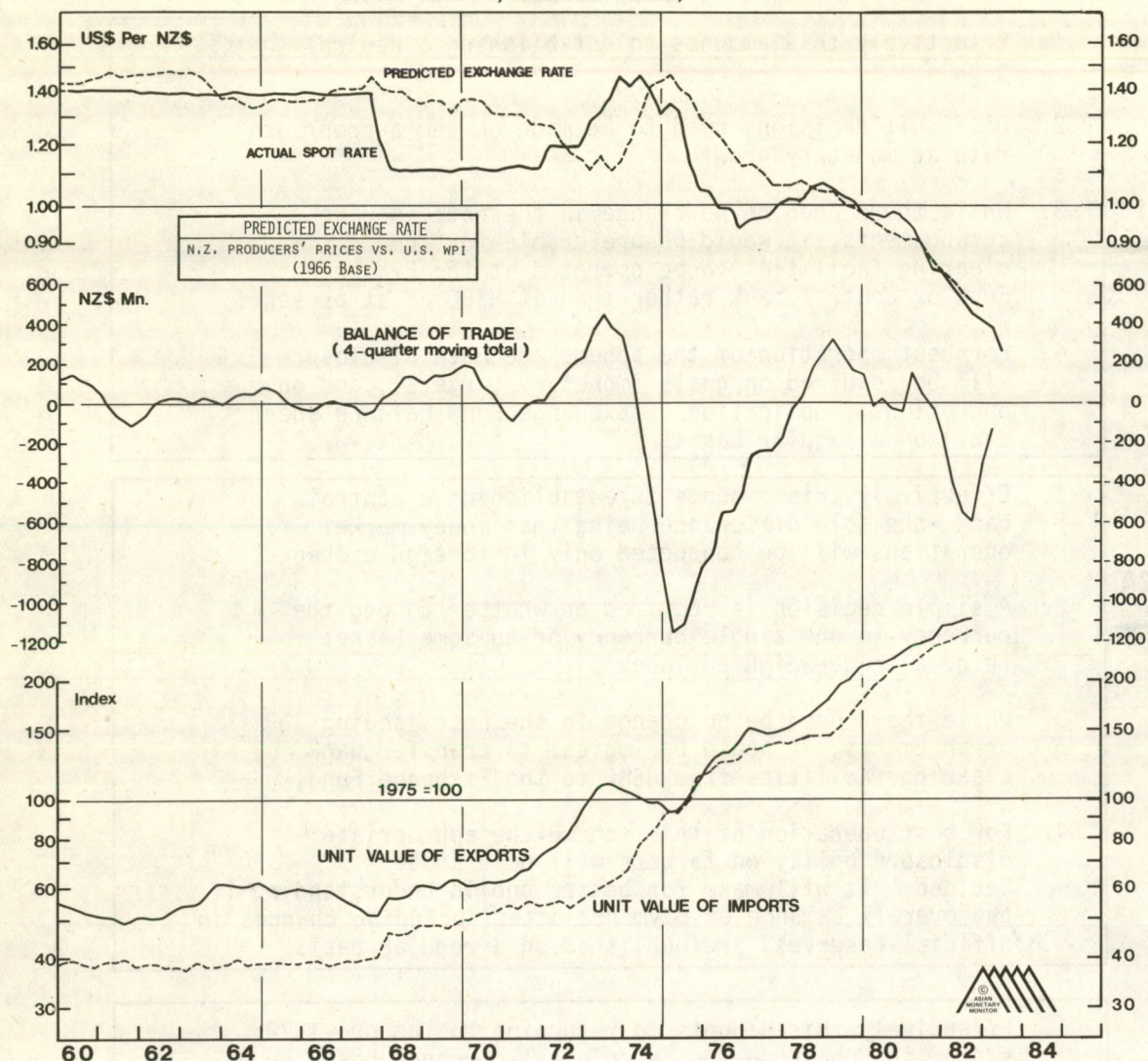
2A

1. Effectively this amounts to establishing a central bank, the sole difference being that money market operations will be conducted only in foreign exchange.
2. A simple decision is required on whether to peg the currency to one single currency or to some basket (e.g. a trade-weighted index).
3. While there need be no change in the note issuing arrangements, it would be logical to transfer bank clearing facilities from HSBC to the Exchange Fund.
4. For best operation of this scheme the appropriate disclosure policy on targets will need to be decided. It will make for better public understanding if the overall balance of payments data (including changes in official reserves) are published on a regular basis.

2B

1. Effectively this amounts to returning to the pre-1972 system in Hong Kong i.e. a colonial currency board type of system with the authorities issuing notes (or CIs) and coin, but not regulating bank reserves.
2. Under this system the authorities' only decision is whether to set the foreign exchange price for bank notes (or CIs) in terms of one currency (e.g. a fixed rate for US\$) or to vary the price (in terms of one currency or in terms of a basket or index).
3. While there need be no change in the note issuing arrangements there is some advantage in all banks being able to buy or sell CIs or notes at the Exchange Fund because this improves the arbitrage between the market for banknotes and the market for commercial deposits and foreign exchange.
4. The only disclosure required by the Exchange Fund will be a daily (or weekly or monthly or even irregular) announcement of the foreign currency rate at which the Exchange Fund is willing to buy and sell CIs.

NEW ZEALAND
CHART 1 : EXCHANGE RATE, EXTERNAL TRADE, AND TRADE UNIT VALUES



NEW ZEALAND

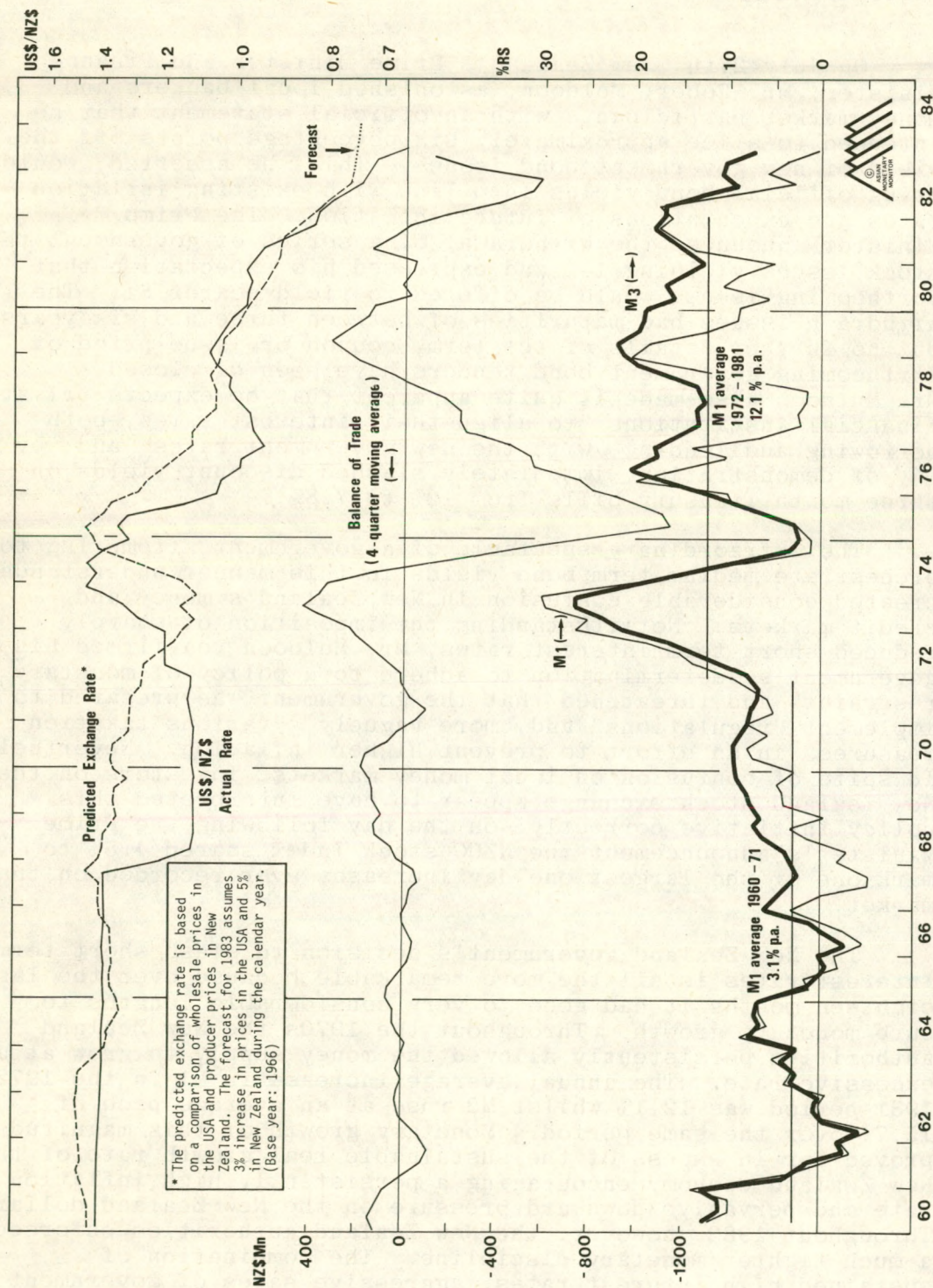
AT A STROKE

On July 27th New Zealand's Prime Minister and Finance Minister, Mr. Robert Muldoon, astonished local bankers and money market participants with an official statement that he intended to slice approximately six percentage points off the yield of new government bond issues. This, he asserted, would bring official bond yields into line with existing inflation rates and expectations of future inflation. The Prime Minister announced the withdrawal of a series of government tap stock issues yielding 14% and expressed his expectation that forthcoming issues would be offered to yield nearer 8%. The withdrawn issues had maturities of between three and six years, but no further details of the term, coupon or issue price of forthcoming government bond tenders have been disclosed. Mr. Muldoon also made it quite apparent that he expects private financial institutions "to align their interest rates, both borrowing and lending, with the new government rates" and, by way of demonstration, immediately slashed discount yields on three month Treasury bills from 12% to 7.8%.

The extraordinary spectacle of a government attempting to orchestrate medium term bond yields in this manner understandably created considerable confusion in New Zealand's money and credit markets. Notwithstanding the imposition of sharply reduced short term interest rates, Mr. Muldoon reaffirmed his government's "determination to adhere to a policy of monetary restraint" and threatened that the government was prepared to implement "regulations" and, more vaguely, "various taxation measures" in an effort to prevent higher inflation. Nevertheless, in spite of confusion on local money markets, investors on the New Zealand stock exchange appear to have interpreted this policy initiative correctly: on the day following the Prime Minister's announcement the NZUC stock index soared 4.8% to mark one of the largest one day increases ever recorded on that market.

The New Zealand government's decision to slash short term interest rates is all the more remarkable because over the last eighteen months it had gone to very considerable lengths to curb monetary growth. Throughout the 1970s the New Zealand authorities persistently allowed the money supply to grow at an excessive rate. The annual average increase in M1 in the 1972-1981 period was 12.1% whilst M3 rose at an average pace of 15.7% over the same period. Monetary growth of this magnitude proved far in excess of the sustainable real growth rate of the New Zealand economy encouraging a persistently high inflation rate and pervasive downward pressure on the New Zealand dollar. Throughout 1982, however, the New Zealand authorities enforced a much tighter monetary discipline. The combination of sustained high interest rates, aggressive sales of government debt to the non bank private sector and a sharp increase in New Zealand's trade and current account deficit all led to significantly slower monetary growth. The year-on-year increase

CHART 2 : MONEY, TRADE AND THE EXCHANGE RATE



in M3 fell from 17.9% in September 1981 to 9.0% in September 1982 whilst M1 growth decelerated from 17.6% to 2.9% over the same period. This restrictive monetary policy, augmented by the implementation of a freeze on wages and prices in June 1982, brought a moderate decline in New Zealand's inflation with consumer price inflation falling from 17% in June 1982 to 12.6% by the end of the first quarter of 1983.

The New Zealand authorities' commitment to a restrictive monetary policy at a time of high inflation brought about a renewed downturn in the domestic economy during 1982, where real Gross Domestic Product declined 0.2%. Nevertheless, in spite of a weaker economy and declining demand for credit from the New Zealand private sector, the authorities found it increasingly difficult to implement a restrictive monetary policy during the final quarter of 1982 and in the first three months of this year. After declining steadily throughout the first nine months of 1982, growth in all the monetary aggregates began to accelerate in the six months from September 1982 to March 1983. M1 increased at an annual (seasonally adjusted) rate of 12.9%, whilst M3 surged 15.1% when measured on the same basis.

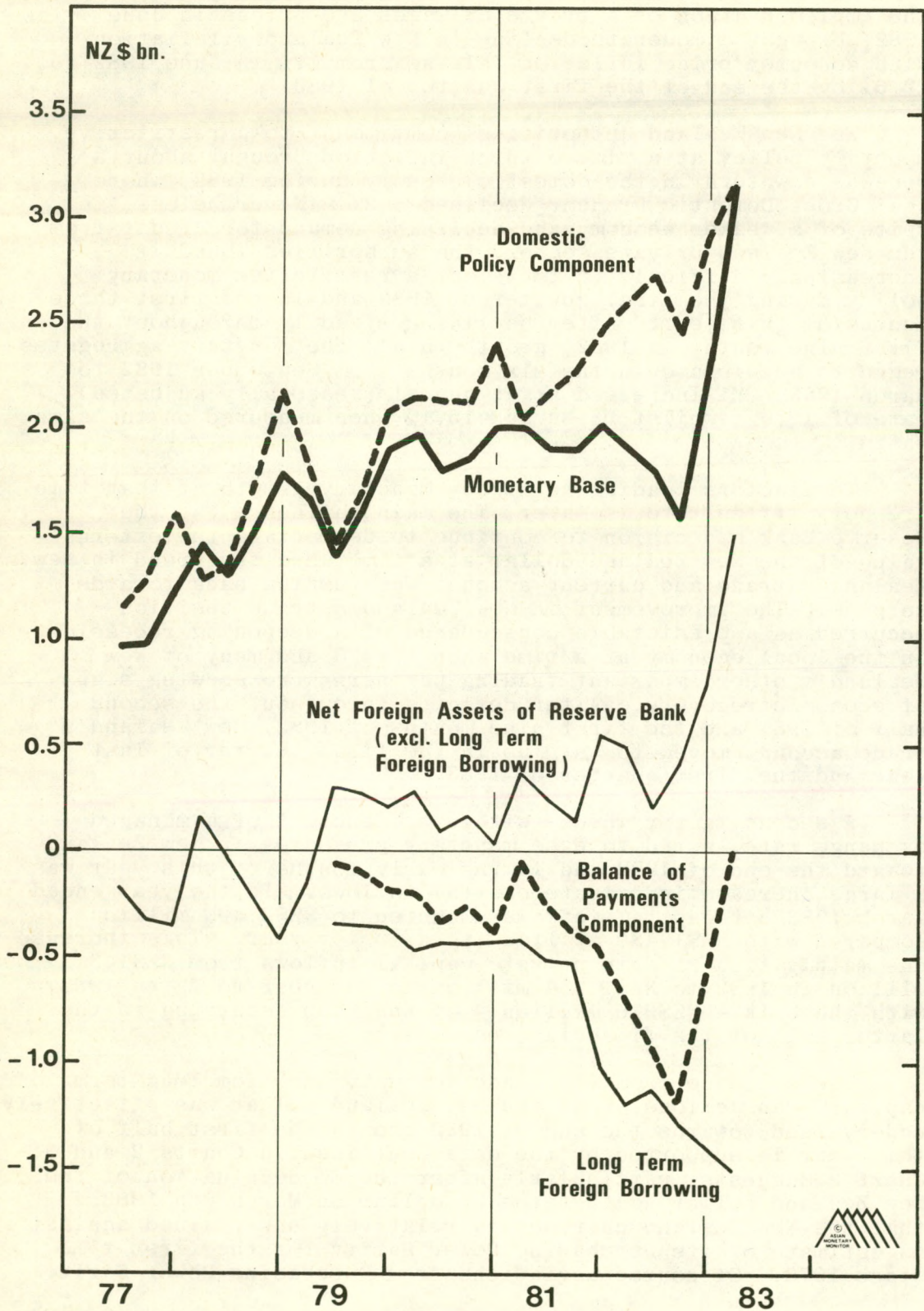
The factors leading to higher monetary growth at that time are not difficult to isolate. The main influence was the Reserve Bank's decision to continue to depreciate the external value of the New Zealand dollar at a time when the trend in New Zealand's trade and current account was turning back towards surplus. The improvement in New Zealand's trade position occurred as a predictable consequence of a deepening recession in the local economy at a time when the US and many of New Zealand's other important trading partners were showing signs of economic recovery. After deficits throughout the second half of 1981 and the first nine months of 1982, New Zealand's trade account moved to surplus in the final quarter of last year and the first quarter of 1983.

A second factor which, within the context of a managed exchange rate, acted to ease monetary pressures in New Zealand toward the end of 1982 and in the early months of this year was a large increase in private capital inflows. In the year ended March 1983 net capital inflows amounted to NZ\$2,495 million compared with NZ\$1,480 million in the prior year. This increase was due mainly to a rise in private capital inflows from NZ\$143 million in 1982 to NZ\$1,284 million in the year to March 1983, with the bulk - NZ\$918 million - of the rise occurring in the latter half of the financial year.

The evidence from the trade account, and from long term capital transactions, that the New Zealand dollar was effectively undervalued towards the end of 1982 and in the first half of this year is supported by the data contained in Charts 2 and 3. Chart 2 suggests, particularly after the 6% devaluation of the New Zealand dollar against the US dollar on March 8th 1983, that the New Zealand currency is relatively undervalued against an estimate of its Purchasing Power Parity for the first time since 1978. Of course deviations from Purchasing Power Parity

NEW ZEALAND

Chart 3 : Sources Of The Monetary Base



estimates of the order of 10%, which is approximately how much the New Zealand dollar now appears to be undervalued against the US dollar, are seen commonly in the analysis of any currency's medium term trend. Nevertheless it would appear that in this instance the New Zealand authorities' decision to depreciate their currency in order to enhance external competitiveness has had a significant monetary impact. For Chart 3 indicates that the balance of payments component of the monetary base has risen sharply since mid-1982. Net foreign assets of New Zealand's central bank, excluding long term foreign borrowings, increased from NZ\$212 million in June 1982 to NZ\$1,498 million at the end of March 1983, contributing to a very substantial and unprecedented rise in the monetary base.

The impact of an effectively undervalued currency was soon felt in domestic money markets. The weighted average of interest rates on trading banks' transferable certificates of deposit, for example, dropped from 16.5% at the end of October 1982 to 12.6% at the start of April 1983. Moreover, for a while, the New Zealand authorities even encouraged the trend towards easier domestic liquidity by reducing trading banks' required reserve deposit ratio to 10% in November 1982 after 15.5% in July.

Nevertheless, during the second quarter of this year, the New Zealand government introduced a range of domestic measures in order to limit monetary growth. The Treasury announced an increase in three and six month Treasury bill yields from 11.25% and 11.5% to 12% and 12.5%, respectively, whilst three year Government debt coupons were increased from 12.5% to 14.0%. The government also raised the interest rate payable on national savings bonds (Kiwi Savings Stock - the so called KISS stock) from 13% to 15% which during its first six weeks of existence attracted over NZ\$500 million in subscriptions from the non bank private sector. In addition, the Reserve Bank indicated that the growth of Trading bank and Finance company lending would be "closely monitored" and asked Trading banks to limit the growth of their nominal lending to no more than one percent each month. Finally, the Reserve Bank raised banks' required reserve deposit ratio from 10% in November 1982 to 31% in April 1983. In spite of an apparently undervalued currency, these domestic measures proved very successful in reining in monetary growth. The year-to-year growth in M1 plummeted to 0.2% in June, whilst M3 growth declined to 7.2% after 12.6% in February.

There can be few doubts that monetary policy in New Zealand had become overly restrictive by the end of the June quarter. Nevertheless, and notwithstanding a further decline in consumer price inflation to 8.3% in the second quarter of 1983, it is completely unjustifiable to argue that the precipitous decline in both short and long dated interest rates inaugurated by the government is compatible either with monetary restraint or with sustainable gains against inflation. The New Zealand authorities move to cut Treasury bill yields to their lowest level since 1978 (see Chart 4), can, in the context of an improving current account and the appearance of

an "undervalued" currency, only be thought of as a precursor to significantly higher monetary growth over the remainder of this year and on into 1984. One need only look back at New Zealand's monetary experience in the six months to March 1983 and note how rapidly monetary growth was rekindled in that period, at substantially higher interest rates than those presently envisaged, to understand how quickly the recent policy change may translate into excess liquidity in the domestic economy.

FORECAST: Two weeks after the decision was taken to reduce short term interest rates, the New Zealand authorities also announced that they are to abandon their managed exchange rate policy and allow the New Zealand dollar to float relatively freely on the foreign exchanges. It is true that this decision, if considered in isolation, would act to moderate monetary growth under present circumstances. Had the authorities' domestic policy measures remained unchanged one might confidently expect the New Zealand dollar to appreciate in the wake of an overall balance of payments surplus, thereby alleviating external pressure for higher monetary growth.

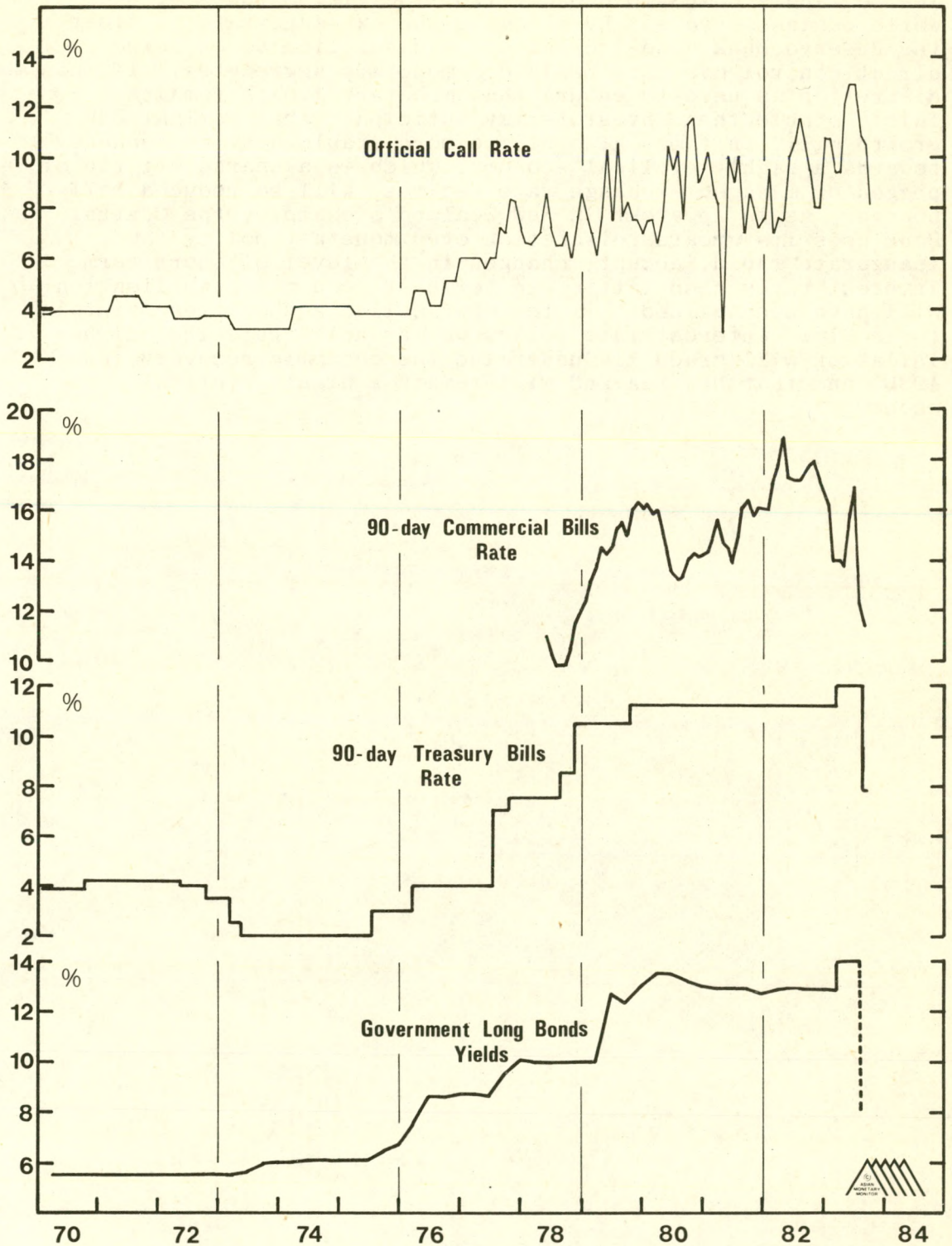
However, the authorities appear to have had committed themselves to following a policy of significantly lower interest rates. Thus even if the Reserve Bank does allow the New Zealand dollar to appreciate in response to an improved external account position, which remains to be seen, the authorities will be obliged to purchase large quantities of official, and other, debt if the newly envisaged short term interest rate structure is to be maintained. In terms of growth in the unadjusted monetary base, therefore, we might expect to see the relative importance of the foreign exchange component decline in favour of Reserve Bank holdings of government securities and other loans. This would be tantamount to arguing that, in slashing short term interest rates and allowing the New Zealand dollar to float, the authorities have effectively substituted a policy where interest rates are now "too low" for a previous policy where the external value of the currency was "too low". In any event, New Zealand is likely to experience substantially higher monetary growth in the coming months.

In spite of the likelihood of higher growth in the monetary aggregates, inflation will very probably continue to decline over the balance of 1983 and during the early months of 1984 as a lagged result of the monetary squeeze in place over the last eighteen months. This combination of higher monetary growth and lower inflation, especially when coupled with an improved trend in the trade account, are exactly the type of conditions which will catalyse a recovery in the New Zealand economy, and equity investors can anticipate further gains on the New Zealand stockmarket.

However there is a more general conclusion which over the longer term is likely to prove to be of greater importance. The New Zealand government's decision to allow the New Zealand

NEW ZEALAND : Chart 4

Short Term Interest Rates And Official Bond Yields



dollar to float on the foreign exchanges would typically be thought of as the first step in a policy designed to shield New Zealand's domestic economy from the vicissitudes of the world business cycle. By allowing the exchange rate to float, the Reserve Bank also increases its discretion to exercise direct control over New Zealand's monetary aggregates. If this discretion is used to ensure that monetary growth remains fairly stable then investors may anticipate that nominal GNP growth will, in time, also become more stable and the tendency towards a highly cyclical economy, which is a characteristic of pegged or managed exchange rate regimes, will be reduced. If however, as is apparent in New Zealand's example, the Central Bank uses its greater discretion over monetary policy to inaugurate rapid, abrupt, changes in the level of short term interest rates then little, in terms of economic stabilisation will have been gained. If the New Zealand authorities maintain their "low" interest rate policy we may anticipate that higher inflation will gradually undermine the economic recovery into 1985, and that New Zealand will remain a highly cyclical economy.

EASIER LIQUIDITY AND FASTER GROWTH AHEAD

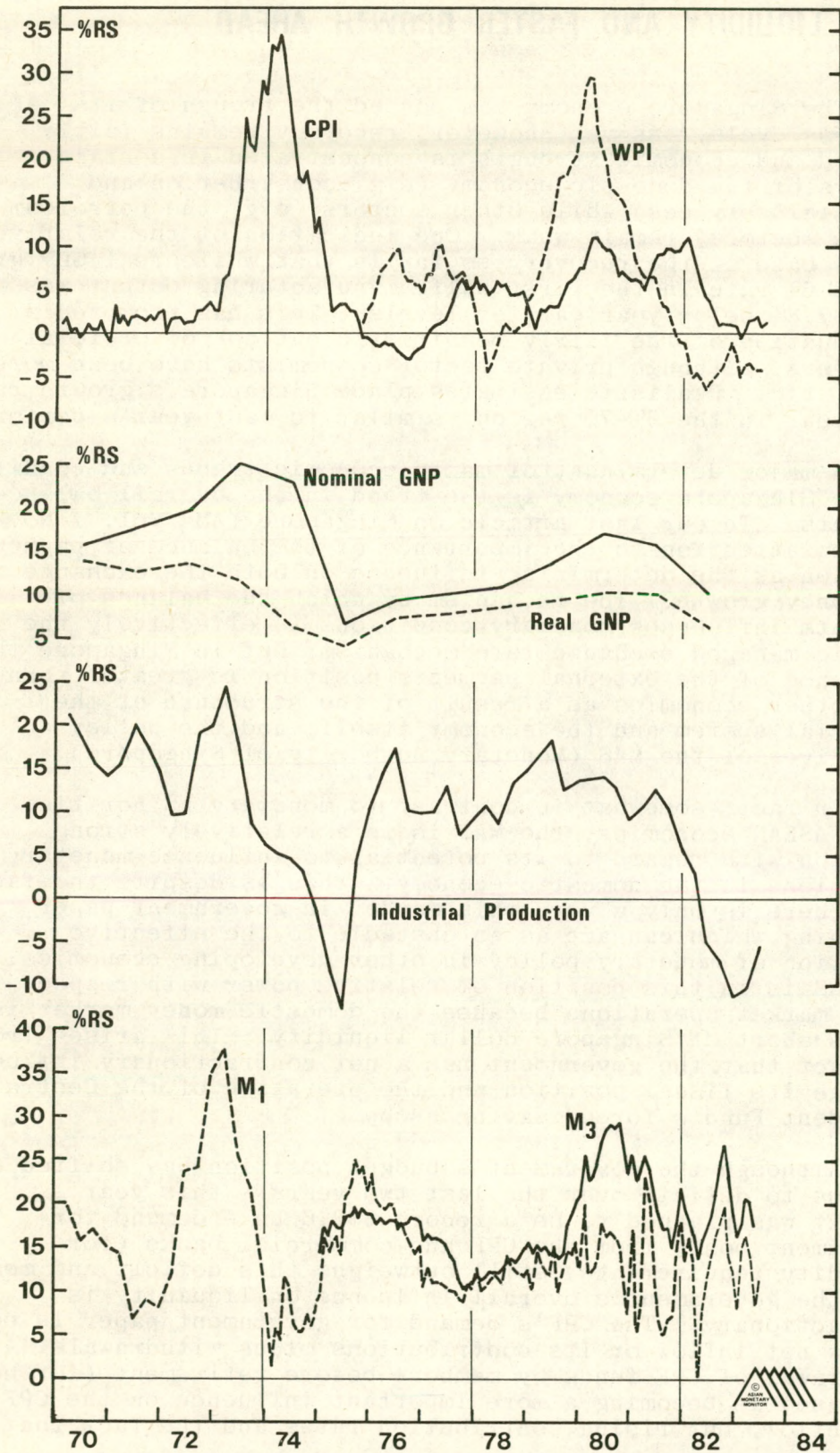
The Singapore economy has passed the trough of its business cycle. As yet, however, recovery remains fairly subdued and economic strength is concentrated in certain sectors of the domestic economy (e.g. construction and financial services) while other sectors (e.g. the petroleum and marine sectors) remain weak. One indication of the relatively narrow base of the recovery so far is that while real GDP grew at a 5.6% rate in the first half, manufacturing output was still 7.8% below year earlier levels. This has prompted a continuation of the fairly pessimistic outlook of official observers, although private sector economists have been more optimistic. Realistic estimates place Singapore's growth rate this year in the 6%-7% region, similar to last year's performance

A major determinant of macro-economic trends and conditions in the Singapore economy is the trend in the overall balance of payments. In our last article on Singapore (AMM Vol. 7 No. 2) we drew attention to the importance of the balance of payments position as the determining influence on both the exchange rate and money growth. The mechanism by which the balance of payments influences monetary conditions is effectively the classic managed exchange rate mechanism, but in Singapore the influence of the external payments position is greater than in most other economies as a result of the structure of the financial system and the economy itself, and the policy objectives of the MAS (Monetary Authority of Singapore).

In fact, somewhat in contrast to monetary authorities in other ASEAN economies, the MAS is in a relatively strong position with regard to its potential to influence monetary conditions in the domestic economy. This is despite the fact that there is only a very thin market in government paper, something which can act as an obstacle to the effective operation of monetary policy in other developing economies. The MAS is in this position of relative power with respect to money market operations because the domestic money market is always short of Singapore dollar liquidity. This arises from the fact that the government has a net contractionary influence through its fiscal position and the operation of the Central Provident Fund's forced savings scheme.

Although the government's budget position has shifted from surplus to deficit over the last two years - this year's deficit was planned to be a record S\$3.6 bn - demand for government bonds from the CPF and commercial banks (for liquidity requirements) still outweighs this deficit and means that the government's overall influence on liquidity is contractionary. The CPF's demand for government paper is equal to its net inflow or its contributions minus withdrawals. Withdrawal of CPF funds by members before retirement (for house purchase) is becoming a more important influence on the CPF's net inflow, but rising contribution rates and the fact that the

SINGAPORE
CHART 1 : MONEY, OUTPUT AND PRICES



population is still young have so far offset this influence and net inflow has continued increasing. Singapore residents are now required to contribute to the CPF the equivalent of 46% of the first S\$3,000 of their annual income, half coming from the employee himself and the other half from the employer. The result of higher contribution rates has been that last year's net inflow into the CPF, at S\$3 bn, was the largest ever.

The net inflow into the CPF is placed to the account of the Ministry of Finance with the MAS, and is converted to government bonds when they are issued. The size of the CPF's deposits determines the size of bond floatations and thus the floatation itself is largely neutral in its monetary impact, the monetary contraction being ongoing and equal to the CPF's net inflow. With the commercial banks' requirements for government paper there is always a 'waiting list' for government paper. The most recent bond floatation, of S\$6.15 bn earlier this year, was oversubscribed with the S\$6 bn 20 year portion going largely to the CPF.

To summarise, even though the government has been more fiscally expansionary of late, requirements for government bonds still outweigh the fiscal deficit so that the government is a contractionary force in monetary terms. This is in contrast, for instance, to Malaysia where the government also operates a forced savings scheme but where in recent years the fiscal deficit has been far larger than the domestic requirement for government bonds. In Singapore's case the situation means that in principle the MAS could easily induce a monetary squeeze. However, in practice this is not possible given the constraints of the persistent balance of payments surplus and the MAS' exchange rate objectives.

The MAS has a variety of monetary instruments at its disposal. Its money market operations can be split into three categories; (i) permanent injections of liquidity through direct currency intervention by outright sales of Singapore dollars, (ii) temporary injections of liquidity through currency swap transactions, mostly US dollar swaps of three months or six months maturity, but occasionally one month, and (iii) other much less used instruments such as commercial bill rediscounting and Treasury Bill issues. The MAS also requires commercial banks to maintain with it reserve balances equivalent to an average of 6% of their eligible liabilities base. Since August of last year this liabilities base has been calculated as an average of the banks' daily liabilities during a two week period starting on a Thursday and ending on a Wednesday. The daily cash reserve to be held against this base is allowed to vary within 1½% on either side of the 6% requirement, with the weekly average only allowed to be 1% above or below the 6%.

The MAS does not fulfil all the functions of a central bank in that it does not issue the currency. The currency issue is the responsibility of the Board of Commissioners of currency. Nevertheless, the currency issue is passive and has 100% foreign reserve backing (banks need to pay for currency with an equivalent amount of foreign exchange) and hence the

CONSOLIDATED BALANCE SHEETS FOR SINGAPORE FINANCIAL SYSTEM

At end of 1981 Financial Year* (Units: S\$ bn.)

Assets

Liabilities

CONSOLIDATED ACCOUNTS OF THE MONETARY AUTHORITIES**

Gold and Foreign Assets (including net IMF positions)	11.61	Currency in circulation	3.69
Bills Discounted, T-Bills, Cash and others	0.42	Balances of commercial banks	1.20
		Deposits of CPF and other institutions	3.67
		Net worth and others	3.47
TOTAL	12.03		12.03

CENTRAL PROVIDENT FUND

Government Bonds	8.99	Members' contributions	12.15
Advance Deposits with MAS	2.89		
Net Current Assets	0.37		
Fixed Assets	0.04	Accumulated surplus	0.14
TOTAL	12.29		12.29

DISCOUNT HOUSES

T-Bills and Govt. Bonds	1.25	Call Deposits of Banks	1.62
Commercial Bills and CDs	0.49	Net worth and others	0.12
TOTAL	1.74		1.74

COMMERCIAL BANKS

Balance with MAS	1.20	Deposits of non-Bank Public	19.78
Cash	0.26		
Money at call with Discount Houses	1.62		
Amounts due from Banks	9.76	Amounts due to Banks	14.05
Loans	25.94		
Investments	2.77		
Others	1.88	Net worth and others	9.60
TOTAL	43.43		43.43

* Due to different reporting dates of the official institutions an exact consolidation is not possible and hence figures given should be viewed largely as illustrative. The balance sheets for the Board of Commissioners of Currency and the Central Provident Fund are those that were obtaining at 31st December, 1981. The balance sheets for the Monetary Authority of Singapore, the discount houses and commercial banks represent their respective positions as at 31st March, 1982.

** Represents a consolidation of the balance sheet of the Board of Commissioners of Currency at 31st December, 1981 and the MAS at 31st March, 1982. Full accounts of the two institutions at these respective dates were as follows:

MONETARY AUTHORITY OF SINGAPORE

Gold and Foreign Exchange	7.70	Balances of commercial banks	1.20
		Deposits of CPF and other institutions	3.67
IMF Reserves and Holdings of SDRs	0.26	Allocation of SDRs	0.04
Bills Discounted, T-Bills, Cash and others	0.42	Net worth and others	3.47
TOTAL	8.38		8.38

BOARD OF COMMISSIONERS OF THE CURRENCY

Gold, Foreign Exchange and External securities	3.69	Currency in circulation	3.69
Cash in Hand	0.03	Advances from MAS	0.03
TOTAL	3.72		3.72

MAS' lack of direct control over it does not in itself represent an obstacle to control of the money supply. The MAS could in theory use the monetary instruments at its disposal to operate on banks' reserve balances and hence influence the monetary base. However, in practice, the MAS attaches little importance to the monetary aggregates and instead policy is conducted with a view to maintaining a stable, and firm, exchange rate. A stable exchange rate is deemed necessary to promote Singapore's growth as a financial centre, although there is the constraint that the rate should not be so high as to undermine the competitiveness of domestic manufacturing industry.

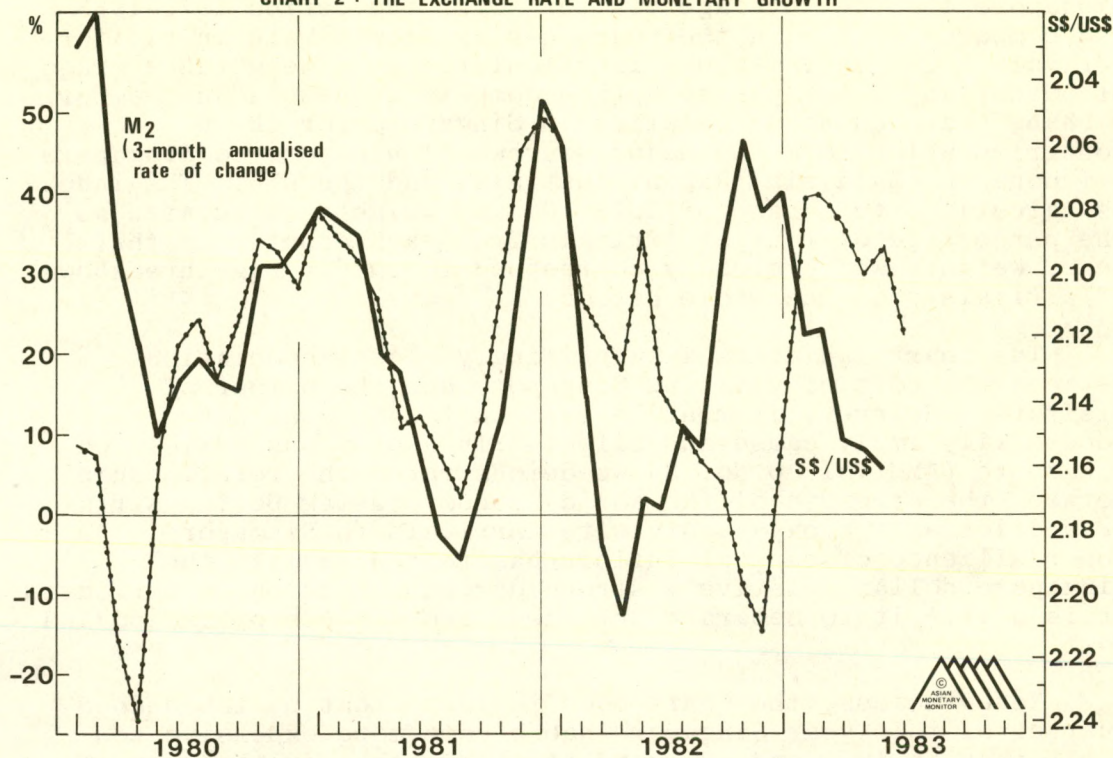
The predominance of the exchange rate objective means that the MAS must supply banks with enough Singapore dollar liquidity to satisfy demand at the existing exchange rate and so means that, at least in the medium term, the course of monetary growth will be determined by fluctuations in the balance of payments. The empirical evidence for this was presented in our last article on Singapore (AMM Vol. 7 No. 2) which demonstrated that over the last three years a firm exchange rate has been associated with rising monetary growth because both are associated with a growing balance of payments surplus. That article suggested that we could see slower monetary growth in the shorter term as a result of a looming deterioration in the balance of payments position.

The updated chart (Chart 2) demonstrates that monetary growth has slowed down sharply, with the most recent statistics, for May, indicating a 3-month annualised growth rate for M2 of 5.8%. The more recent behaviour of the exchange rate and also of another indicator, the stock market, suggests that this trend of tightening liquidity may have continued beyond May.

The reason for the slowdown in monetary growth is probably a temporary deterioration in the balance of payments. This is not particularly evidenced by the behaviour of the trade account, the deficit on which has continued to run at a similar annual rate to last year's S\$15.9 bn, although June's figures do show a marked pick-up in import growth (to 12.2% year-on-year). It is more likely to be the result of a deterioration in non-trade foreign exchange earnings, including invisible earnings and capital inflows, which finance Singapore's large deficit on external trade.

One reason for a slowdown in non-trade foreign exchange earnings could be that following the devaluations of the Indonesian Rupiah, the Philippine Peso and the Australian and New Zealand dollars, and the depreciation of the Hong Kong dollar, the Singapore dollar is now a very strong currency on a regional basis. This could be particularly expected to affect earnings from tourism, for instance, which last year contributed S\$3.2 bn to the overall balance of payments. Following the imposition of a US\$220 per person exit tax by the Indonesian authorities, total tourist arrivals in Singapore dropped by 1.7% from the previous year in the first half. After the regional currency devaluations this trend could be expected to have continued.

SINGAPORE
CHART 2 : THE EXCHANGE RATE AND MONETARY GROWTH



SINGAPORE : CHART 3
Real Effective Cost of Visiting and Number of Arrivals

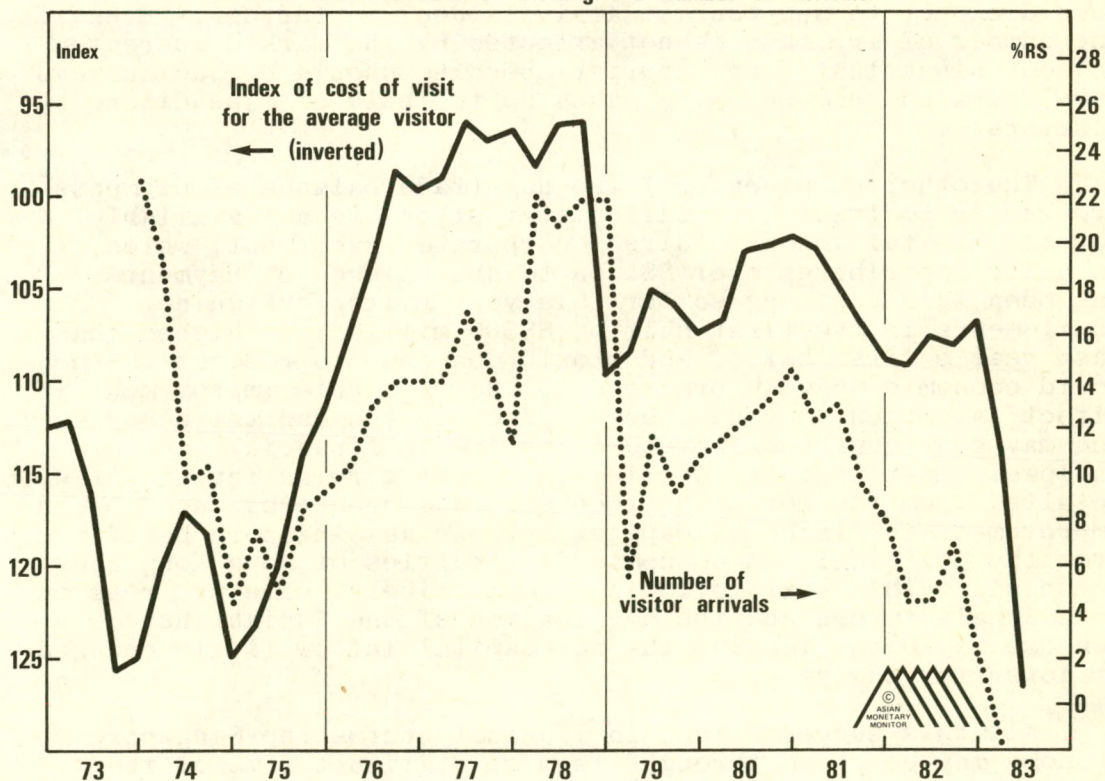


Chart 3 shows a measure of the real cost of visiting Singapore for the 'average visitor' over the period 1973-1983 and compares this with the year-to-year growth rate in visitor arrivals. The cost measure is calculated as a weighted average of purchasing power parity (price competitiveness adjusted for exchange rate changes) relative to Singapore for the 5 countries which form the major sources of visitors to Singapore - Indonesia, Malaysia, Japan, Australia and the USA. The index is calculated to a base of 1978=100 and weights calculated as the percentage of tourist arrivals from each country in that year, weights which closely correspond to the average breakdown of arrivals over the whole period.

The Chart indicates a surprisingly close association between the cost of visiting Singapore and the number of visitors. However, it must be said that this does not necessarily imply cause and effect. In a previous article on Singapore (AMM Vol. 6 No. 3) we demonstrated the relationship between the strength of the world economy (using US industrial production as a proxy) and visitor arrivals to Singapore. As the resilience of capital inflows has tended to make the Singapore dollar relatively strong during recessionary periods, it is difficult to separate out these two effects of demand and cost.

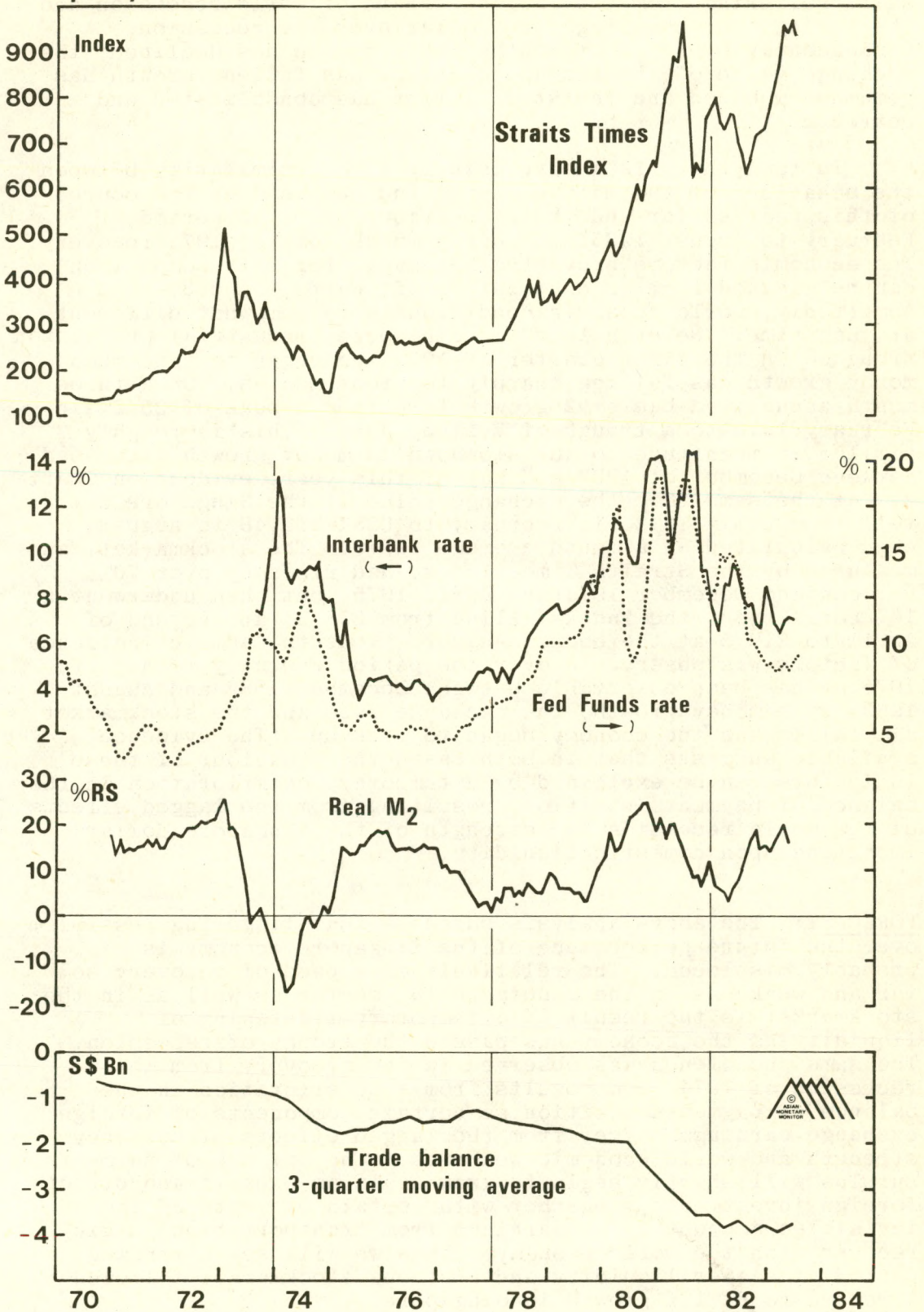
Nevertheless, the Chart does indicate that by the second quarter of this year Singapore had become more expensive to visit than in 1973 and 32% more expensive than at the time of peak tourist activity in 1978. It seems sensible to believe that as travel plans are generally made in advance, the cost of visiting should operate with a lagged effect, and hence we should expect to see tourist arrivals decline further. Even if the number of arrivals is not affected by the marked increase in cost since last year, tourist spending should be, as surveys have revealed that shopping makes up the bulk of expenditure by visitors.

The other components of the non-trade balance of payments are harder to track as detailed statistics are not available. For the capital account, direct corporate investment, which annually contributes over S\$1 bn to the balance of payments, has been fairly strong so far this year (with foreign net commitments in the first half of S\$809 million, 9% higher than last year's first half), and should continue to recover as the world economic upswing progresses. However this improvement in direct investment may have been offset on the capital account, and may continue to be, by some decline in financial capital inflows. Last year the decline in direct foreign investment which resulted from the worldwide recession was counterbalanced by an improvement in financial capital inflows as Singapore benefited from the political and economic difficulties of Hong Kong and Indonesia. This year following, respectively, some progress on Hong Kong's future and the devaluation of the Rupiah the reverse may occur leaving the net capital inflow little changed or lower for the year.

All this suggests that in liquidity terms the Singapore economy may be going through its most difficult time of the economic cycle at the moment. Imports have begun to pick up as

Singapore : Chart 4

Liquidity Indicators, the Trade Account and the Stock Market

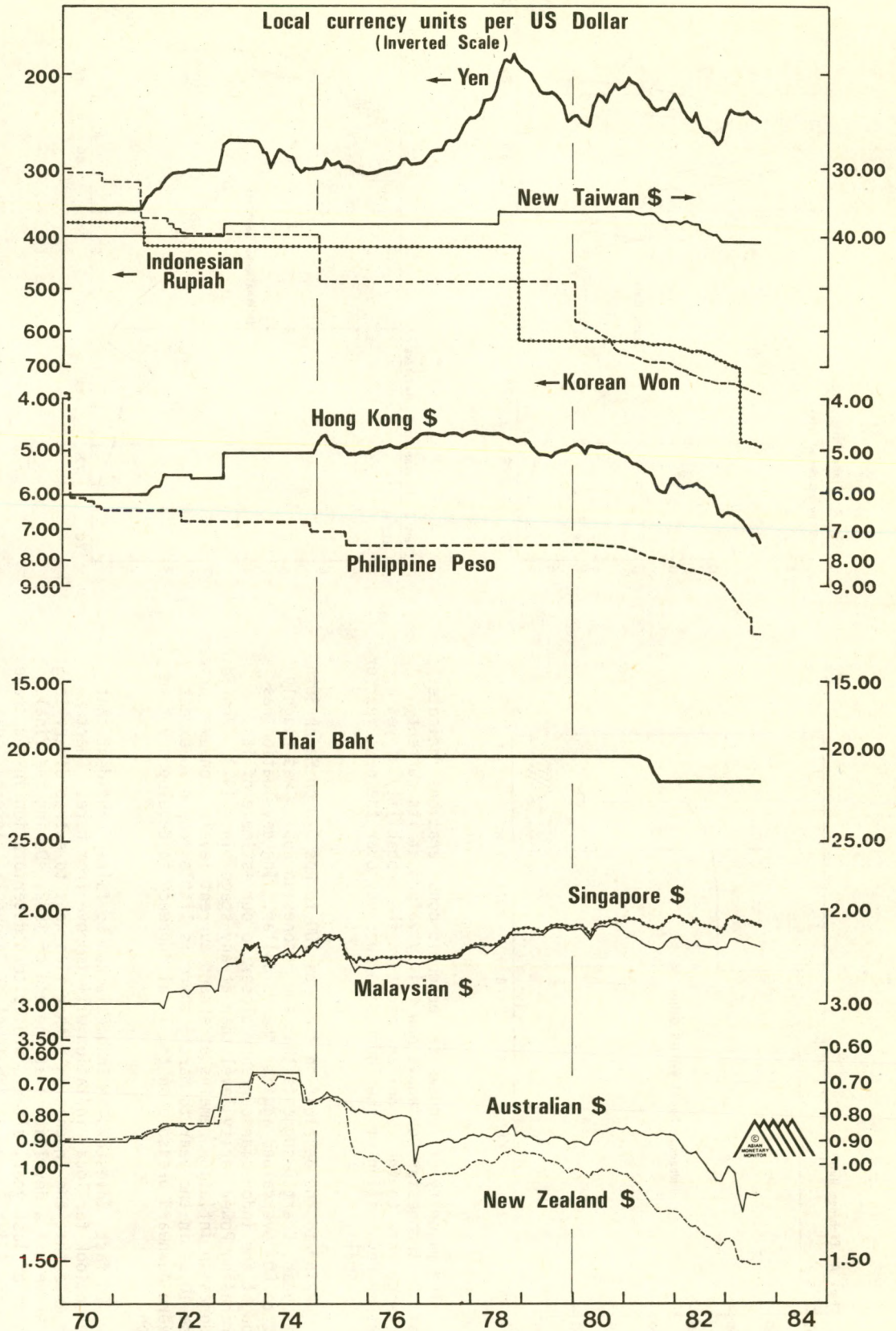


the economy begins to recover and demand for raw materials and capital goods grows, while invisible and capital earnings are still suffering from the lagged effects of world recession and the strength of the Singapore dollar over the recession. Consequently over recent months money growth has declined, the exchange value of the Singapore dollar has fallen, growth has remained subdued and the stock market has consolidated and corrected.

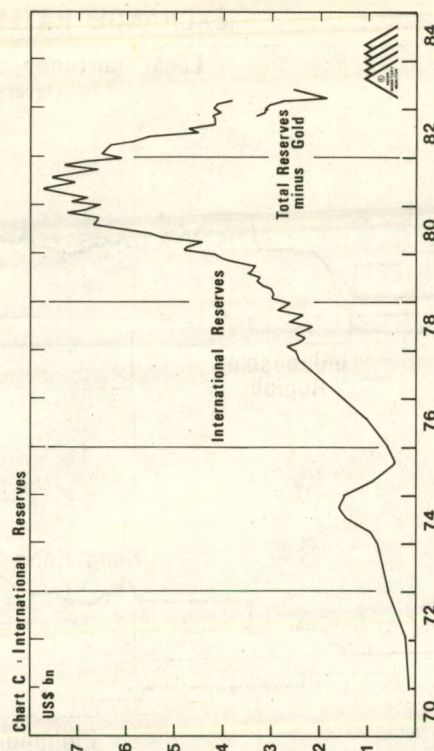
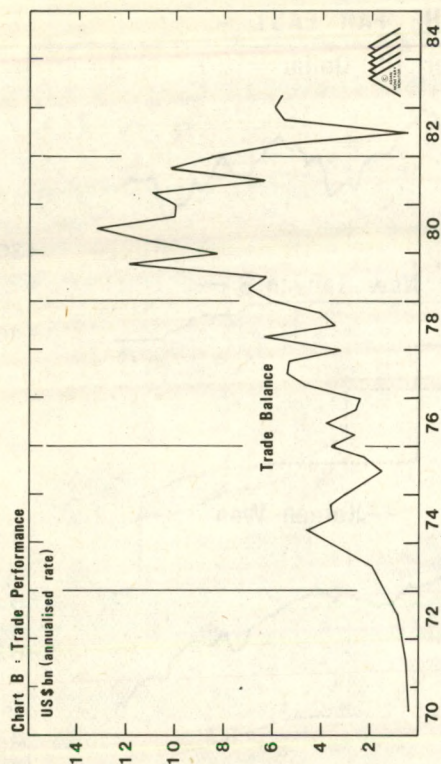
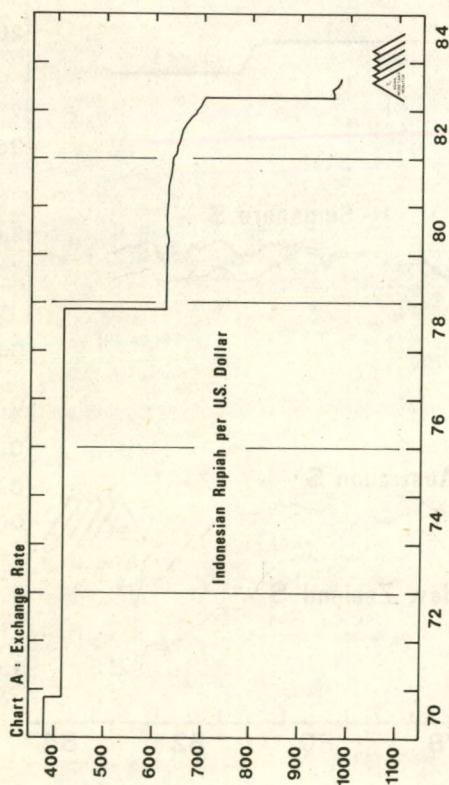
In fact there is a surprisingly strong similarity between the behaviour of the main economic indicators over the course of this year so far and their behaviour over the period February to August 1975, the early months of the 1975 recovery. The economic factors providing the basis for this comparison can be gleaned from an examination of Charts 1 and 3. Admittedly, world economic conditions were somewhat different at that time. Nevertheless, in Singapore, industrial production troughed in the first quarter of 1975 and began to rise when money growth was falling sharply for four months. On a three month annualised basis M2 growth fell from a peak of 35.5% in February 1975 to a trough of 7.1% by June. This is roughly similar in magnitude to the slowdown in money growth witnessed between December of 1982 and May of this year, evident on Chart 2. At the same time the exchange value of the Singapore dollar fell from US\$1=S\$2.26 in February to US\$1=S\$2.48 in August, when calculated on a month average basis. The stockmarket, as measured by the Straits Times Index, had risen by over 70% between end December 1974 and April 1975, but then underwent a 16% correction, the index falling from 258.34 at the end of April to 217.5 at the end of August. Thus the same coincidence of factors was observable over the period February to August 1975 as has been observable between December 1982 and August 1983, with money growth, the exchange rate and the stockmarket all falling as the economy began to pick up. The evidence available suggests that in both cases the behaviour of these indicators can be explained by a temporary deterioration in the balance of payments position, resulting from the lagged effects of the world recession and strength of the Singapore dollar impacting upon domestic liquidity.

FORECAST: The above analysis suggests that lingering pessimism over the future performance of the Singapore economy is probably misplaced. The relatively slow pace of recovery so far and weakness in the manufacturing sector as well as in the stockmarket is the result of a temporary tightening of liquidity as the economy has passed the trough of recession. The same phenomenon was observed in the recovery from the recession of 1974, and results from a deterioration in the balance of payments position as certain components of foreign exchange earnings suffer from the lagged effects of currency strength and world economic weakness. The balance of payments surplus will shortly begin to grow again as exports and direct foreign investments, together with certain elements of the invisibles account (e.g. earnings from transportation) begin to recover with the world economy. Then we will see a renewed period of easier liquidity and a strong stockmarket followed by a return to 8%-10% growth in Singapore.

EXCHANGE RATES IN THE FAR EAST



INDONESIAN RUPIAH



The majority of fundamental economic considerations indicate that the Indonesian Rupiah is now fairly valued at its current exchange rate to the US dollar, and that the probability of yet a further devaluation of the Indonesian currency over the next year or two is small.

Prior to the devaluation from Rps 700 to Rps 970 on March 30th this year, Chart D suggests that the Indonesian Rupiah was roughly 40% to 50% overvalued against the US dollar. The devaluation has brought the Indonesian currency closer to our estimate of its Purchasing Power Parity level than at any stage since 1973. Providing Indonesian inflation remains at around current levels (consumer prices rose 10.6% in the year to March) there is little reason to expect severe downward pressure on the local currency to develop any time soon.

In fact, investors in Indonesia can be fairly confident that the outlook for local inflation will improve from here. Chart E suggests that the Indonesian authorities went to extraordinary lengths to stave off a devaluation at the end of 1982. During the final months of last year, after a precipitous deterioration in the trade account (Chart B) and in the level of Indonesia's International

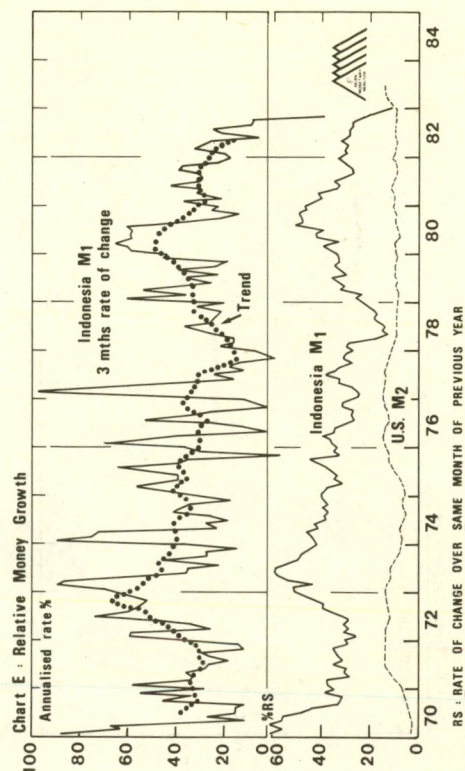
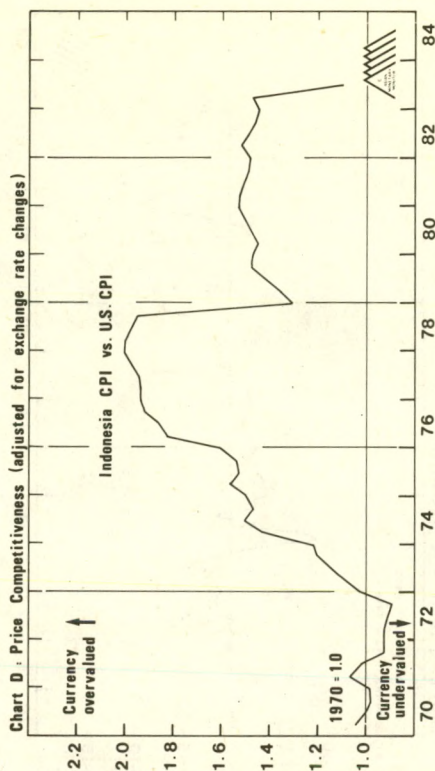
Reserve holdings (Chart C), domestic monetary growth contracted at an annual pace approaching 20%. A decline in the money supply of this order is quite unprecedented in the history of Indonesian monetary policy since 1970 and has brought about a decline in the year-on-year rate of growth in M1 to 10% - the lowest level in more than a decade. Slower monetary growth in the second half of 1982 represented a continuation of a trend which started in mid-1980 and - in spite of higher import prices in the wake of devaluation - is virtually certain to lead to steady or lower rates of inflation into 1984.

The March devaluation was brought about, essentially, because in the wake of the OPEC oil price reduction the Indonesian authorities proved unwilling to subject the domestic economy to a prolonged, painful recession simply to maintain the external value of the Rupiah. What guarantee is there, now that the external constraint has been lifted, that the Indonesian government will not again overly stimulate the domestic economy as happened after the devaluation in 1978? Of course there is none, and over the next two years overseas investors must watch carefully to ensure that domestic monetary policy is not allowed to become too loose. Nevertheless recent official statements by Mr. Suharto, Indonesia's President, should provide a measure of comfort to foreign investors, for he has warned Indonesians that they will have to settle for lower levels of real growth than those typical of the 1970s. If Mr. Suharto can garner sufficient political support to enforce this view, the longer term outlook for the Rupiah may improve from here, since it implies that the Indonesian authorities will be less likely to risk the re-emergence of higher inflation in a dash for short term growth.

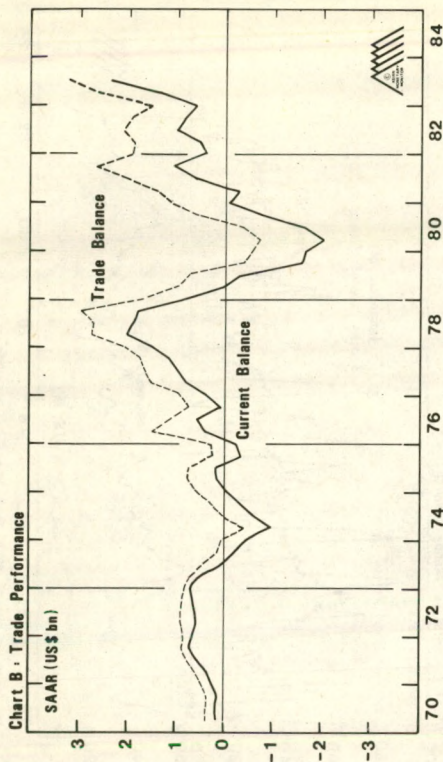
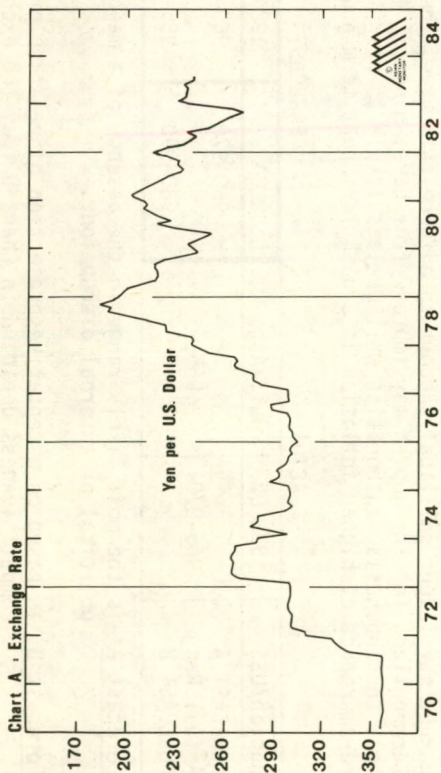
Rupiah/US\$	ACTUAL		FORECAST	
	1983 Q2	Jul.-Aug.	Q4	1984 Q1
FORECAST A				
Actual Range		965	960-970	960-970
FORECAST B	965-970		980-990	985-995

Forecast A is the most likely range in the absence of a major political or external disruption.

Forecast B is based on a tentative projection of relative price competitiveness depicted in Chart D i.e. the exchange rate required to bring US and local price levels approximately into line.

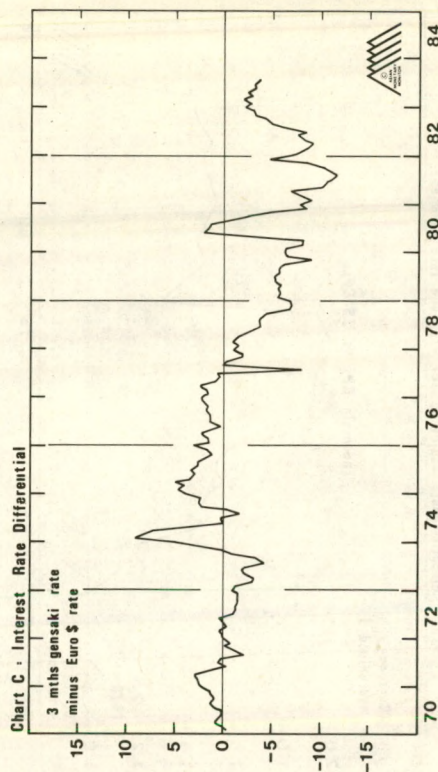


JAPANESE YEN



Fundamental economic analysis suggests that the yen will remain a strong currency during the remainder of 1983. The combination of a restrained monetary policy and a burgeoning current account surplus in Japan has already enabled the yen to appreciate substantially against most European currencies this year. For example, the yen appreciated nearly 6.6% against the Deutschmark in the six months up to the end of July. However the yen has weakened somewhat against a strong US dollar falling to ¥247.10 on 12th August. This marked the yen's weakest point since December 1982.

The yen's temporary weakness against the dollar probably reflects the emergence of higher interest rates in the US following a slight adjustment in Federal Reserve monetary policy. Chart E shows that the growth of M2 in the US since the start of 1983 had been very rapid. Other US monetary aggregates had also recorded higher growth rates with, for example, the year-to-year growth in M1 rising to a high of 13.5% in July. The Federal Reserve's accommodative monetary policy earlier this year was a powerful force behind the strong recovery in the US economy where real GDP surged to an annualised growth rate of 9.2% during the second quarter of this year. In response to rapid monetary growth and evidence of a strong recovery the Federal Reserve has recently adopted a moderately



more restrained stance, pushing short US interest rates approximately one hundred and fifty basis points higher, to roughly 10%. However, it is important to recall that the Federal Reserve's present monetary guidelines are by no means restrictive when compared with previous policies, or with monetary policy in Japan. The US authorities have rebased their target growth path for M1 and now hope for between 5% and 9% annualised growth in that variable during the second half of this year. It is probable that the Federal Reserve has already tightened monetary conditions sufficiently to ensure that this (unambitious) target is achieved. This being so there is little reason to expect US interest rates to move any higher over the remainder of 1983.

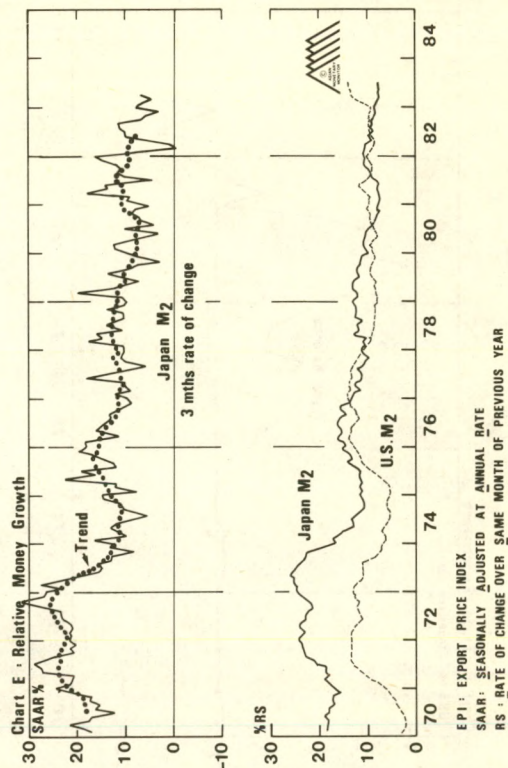
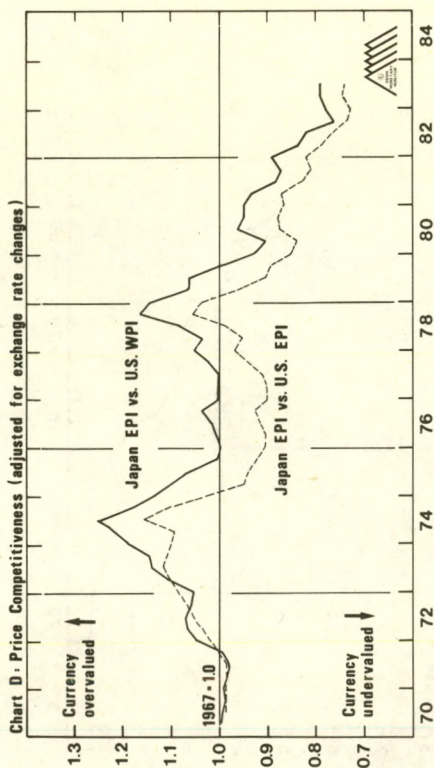
In these circumstances, the favourable fundamental outlook for the Japanese currency is likely to be reflected in a rising yen/US dollar rate in the coming months. Chart D suggests that the yen is anything up to 20% undervalued against its US counterpart and given a strong recovery in the US, this is likely to lead to a further substantial improvement in Japan's trade account (see Chart B). Indeed Japanese export growth over the last six months has outpaced import growth by over 10%. Of course trade and service flows are not the only component of the external account, but during the second quarter of 1983 large long term capital outflows measuring US\$3.726 billion were more than outweighed by a current account surplus of US\$6.014 billion.

ACTUAL FORECAST

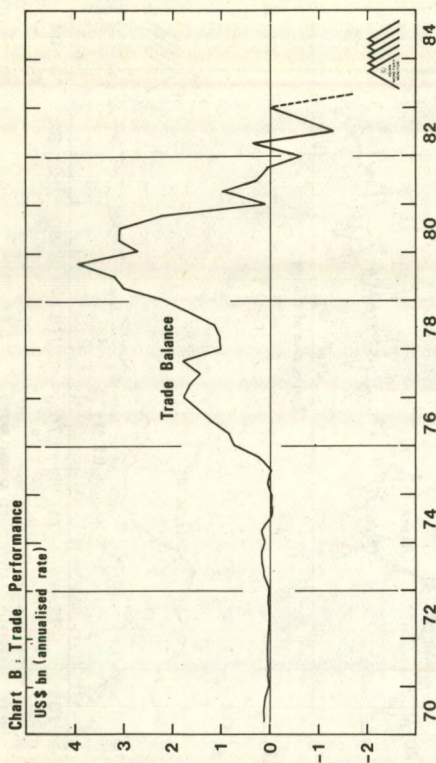
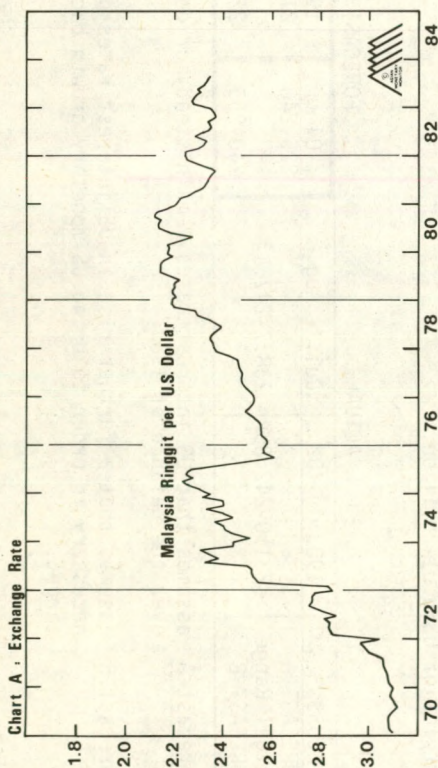
Yen/US\$	1983	Q2	Jul. - Aug.	Q4	1984 Q1
FORECAST A				225-240	215-230
Actual Range	231.0-242.8		238.7-247.1		
FORECAST B				240-255	225-245

Forecast A assumes that US interest rates remain steady or decline over the balance of 1983.

Forecast B assumes that a further rise in US interest rates proves necessary in order to bring US monetary growth back to target.



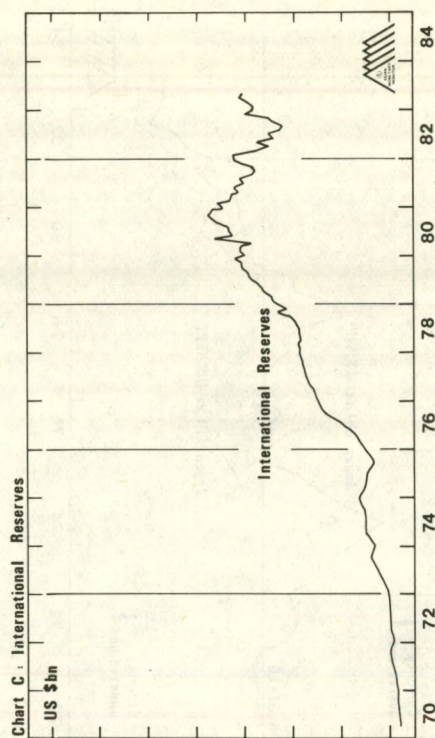
MALAYSIAN RINGGIT

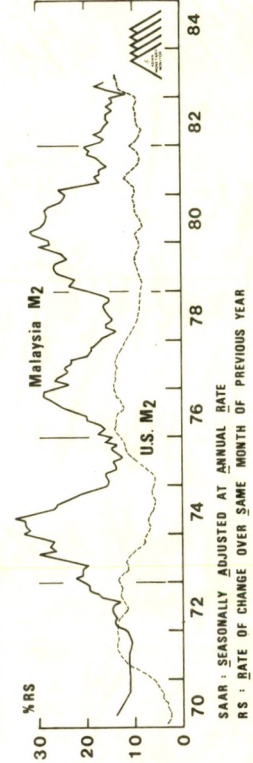
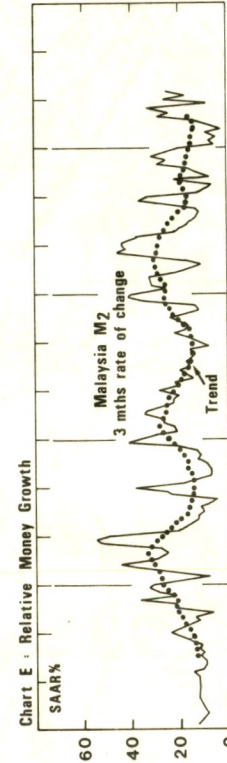
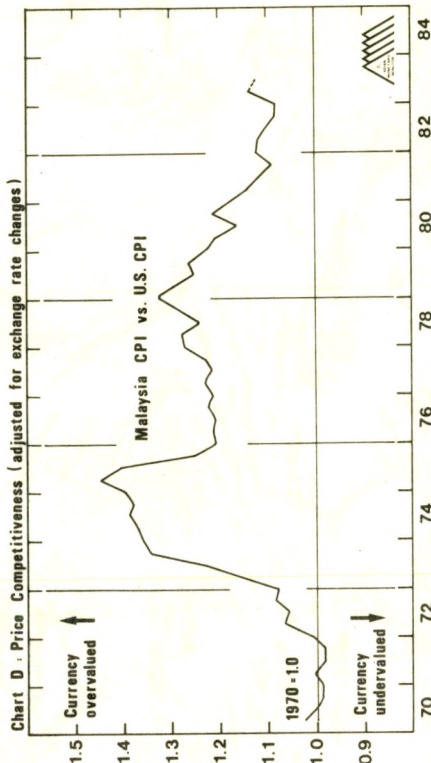


Prospects for the Malaysian economy have become brighter over the past few months as the prices of major commodities have risen. The price of palm oil unexpectedly surged by roughly 50% between June and August as a result of the failure of US soyabean crops because of a severe drought. Reflecting the improved outlook for the Malaysian economy the Deputy Finance Minister recently raised the official forecast for economic growth for this year to 5.8%.

The possible danger posed by higher commodity prices is that the resulting recovery in the trade balance could be reflected in an upswing in monetary growth if the authorities continue to manage the Malaysian Ringgit rigidly against the Singapore dollar. It can be seen from Chart E that the commodity booms of 1973 and 1979 as well as the uptick in commodity prices in 1976 were all mirrored by a rapid acceleration in the money supply. There is valid cause for concern that, despite the Bank Negara Malaysia's (BNM) commitment to a sound money policy, the same may occur in this cycle if the government fails to reduce its budget deficit by a significant amount.

During the 1970's in some senses the government's fiscal position acted as an 'automatic stabiliser' with respect to the trade position's influence on the money supply. During commodity price





upswings the domestic funding of the budget deficit acted against the stimulus to monetary growth arising from growing trade surpluses. This happened as the budget deficit was favourably influenced by growing revenues from export duties, while demand for government bonds from the Employees' Provident Fund tended to increase because members' incomes and hence their contributions were increasing.

However, since 1980 the size of the budget deficit has become much greater than the domestic requirement for government bonds. At the same time the budget position has probably become less sensitive to movements in commodity prices as revenues from non-oil export duties have become much less significant and revenues derived from oil have become more important. For instance, in 1976 nearly 40% of the increase in government revenues for the year was attributable to the increase in receipts from export duties. Then non-oil export duties accounted for 16% of total government revenues. In 1982 (which admittedly was a recession year) receipts from non-oil export duties accounted for only 2% of total government revenues.

In conclusion, unless the government significantly reduces its spending from current levels any marked pick-up in commodity prices will put upward pressure on money growth unless the BNM appreciates the exchange rate, narrowing the discount to the Singapore dollar. The BNM's commitment to monetary rectitude suggests that they should take this option and allow the Ringgit to appreciate. A marked appreciation may not be necessary if commodity prices stabilise or if there is a significant scaling back of government expenditures in the October budget. However, under any circumstances indications are that the Malaysian Ringgit should be a relatively firm currency over the coming year.

M\$/US\$	ACTUAL		FORECAST	
	1983	Q2 Jul.-Aug.	Q4	1984 Q1
FORECAST A			2.28-2.35	2.18-2.28
Actual Range	2.293-2.355	2.329-2.367		
FORECAST B			2.60	2.60

Forecast A is the most likely exchange rate in the absence of some major political or other external disruption.

Forecast B is based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate necessary to bring US and local price levels into line.



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KEY TO SYMBOLS USED IN THE CHARTS

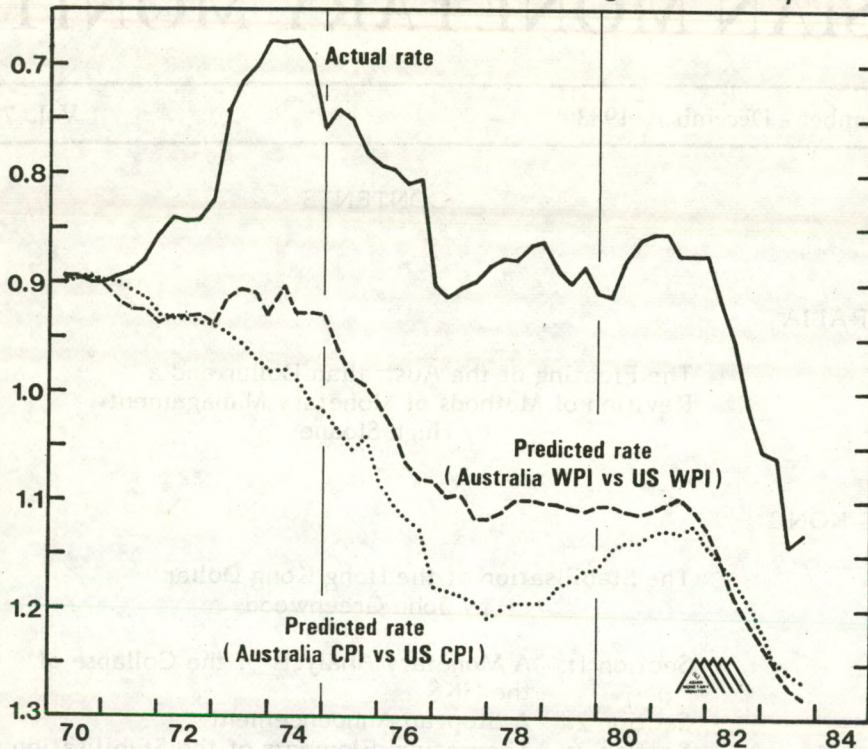
% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

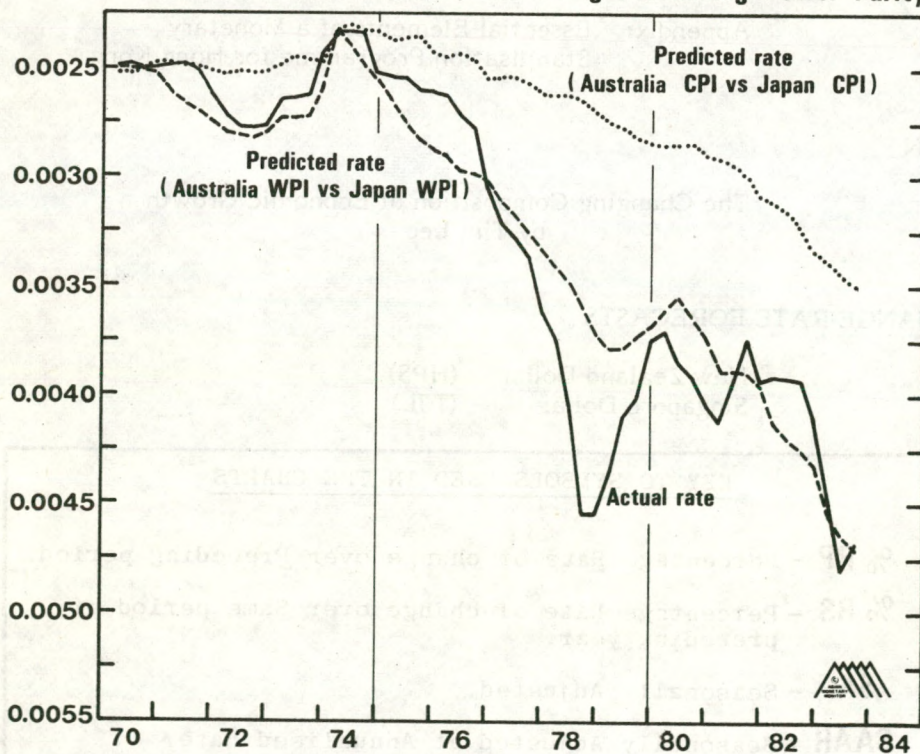
SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

Australia: Chart 1
Predicted A\$/US\$ Using Purchasing Power Parity



Australia: Chart 2
Predicted Australian Dollar/Yen Using Purchasing Power Parity



AUSTRALIA

THE FLOATING OF THE AUSTRALIAN DOLLAR AND A REVISION OF METHODS OF MONETARY MANAGEMENT

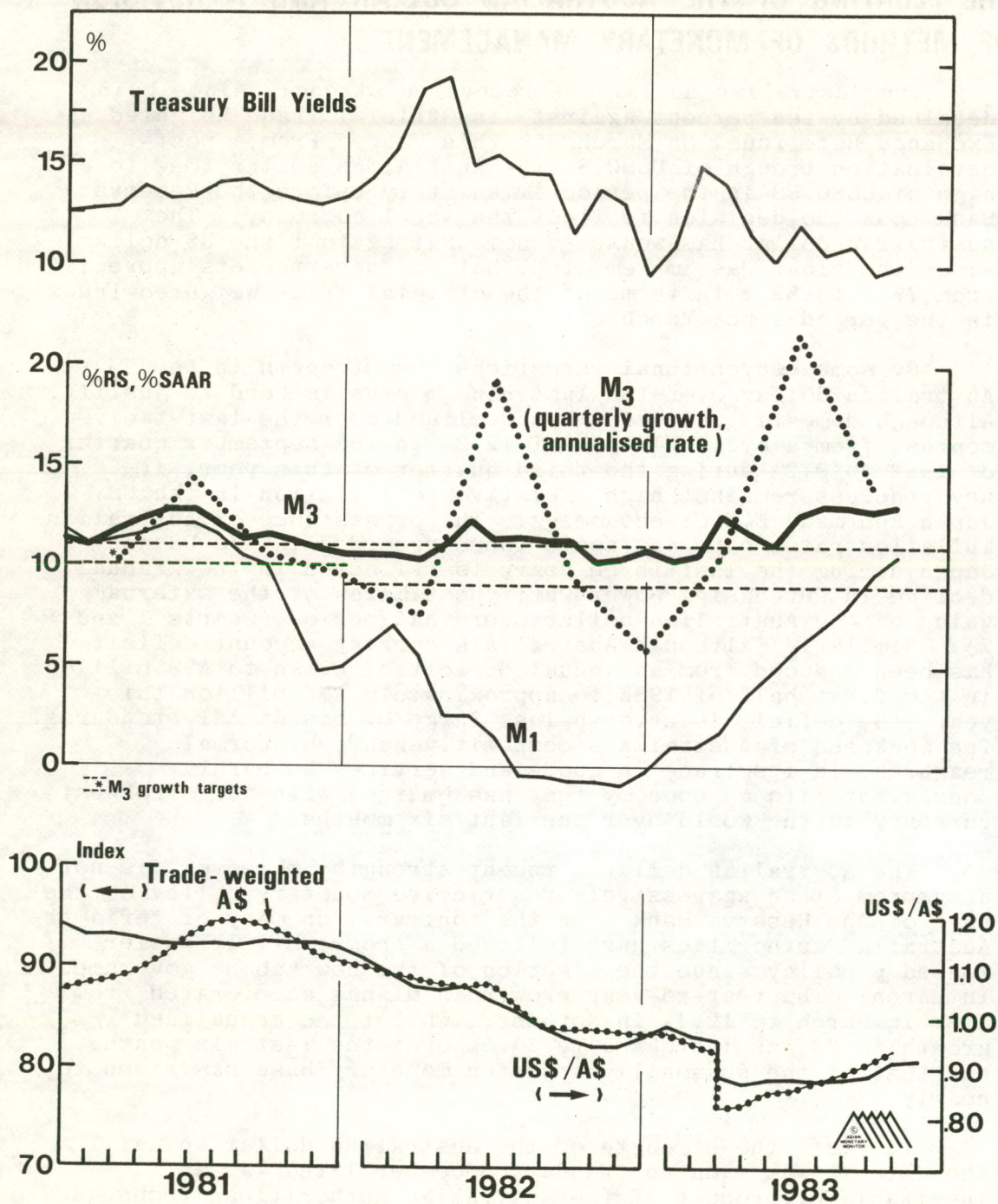
The Australian dollar has recovered strongly since being devalued by ten percent against its Official Trade Weighted Exchange Rate Index on March 8th this year. From a post-devaluation trough of US\$0.84 the Australian dollar rose to a high of US\$0.93 in the period immediately before the Reserve Bank took the decision to float the local currency. The Australian dollar has weakened somewhat against the US dollar since the float was implemented, but has nevertheless appreciated from 73.2 to 82.2 in terms of the official Trade Weighted Index in the period since March.

By some conventional yardsticks the strength in the Australian dollar over the last nine months is hard to justify. Although domestic inflation has declined over the last twelve months, from a cyclical peak of 12.3% in the September quarter of 1982 to 9.2% during the third quarter of this year, it nevertheless remains "high" relative to inflation in the US, Japan and many E.E.C. economies. The persistence of Australian inflation rates over and above those recorded in the US and Japan during the last three years is reflected in the gradual decline in Purchasing Power Parity estimates of the external value of the Australian dollar over that period (Charts 1 and 2). Similarly, although Australia's current account deficit has been reduced from an annual deficit of close to A\$9 billion in the first half of 1982 to approximately A\$6 billion this year, the deficit is nevertheless large by historical standards. The weakness of Australia's competitiveness, by normal measures, in its trade in goods and services is hardly consistent with an economy that has emerged with the strongest currency in the world over the last six months.

The Australian dollar's recent strength, moreover, is not a symptom of an aggressively restrictive monetary policy on the part of the Reserve Bank. On the contrary, on many criteria the Australian authorities have followed a progressively easier monetary policy since the election of the new Labour government in March. The year-to-year growth in M1 has accelerated from 1.8% in March to 12.4% in November, whilst the annualised growth in M3 has increased to 14.5% over the last six months and that of the seasonally adjusted monetary base has risen to nearly 18%.

In fact, the strength of the Australian dollar up until the date it was floated (Monday, December 12th) was an inevitable by-product of the Australian authorities' techniques of macro-economic management. In contrast to economies such as Japan, the US and the UK, where official intervention on the foreign exchanges is negligible and where exchange rate trends are generally a symptom of the restrictiveness or otherwise of monetary policy and the underlying competitiveness of domestic output, Australia - until recently - operated a heavily managed

AUSTRALIA : CHART 3 **Money, Exchange Rate And Interest Rates**



exchange rate system. The key contrast between the operation of macro-economic management in Japan, the US and the UK and Australia was simply that whereas the Bank of Japan, the Federal Reserve and the Bank of England each target monetary growth (either directly through control over the monetary base, or indirectly via the management of short dated interest rates) by influencing domestic policy variables, the Reserve Bank targeted monetary growth by manipulating the external value of the Australian dollar.

Thus just as in the US or the UK where the authorities' response to above target monetary growth is typically to raise domestic interest rates so, in Australia, the authorities responded to above (below) target monetary growth by gradually appreciating (depreciating) the Australian dollar against its Trade-Weighted Exchange Rate Index. This approach to macro-economic management was similar to that still employed by the Monetary Authority of Singapore.

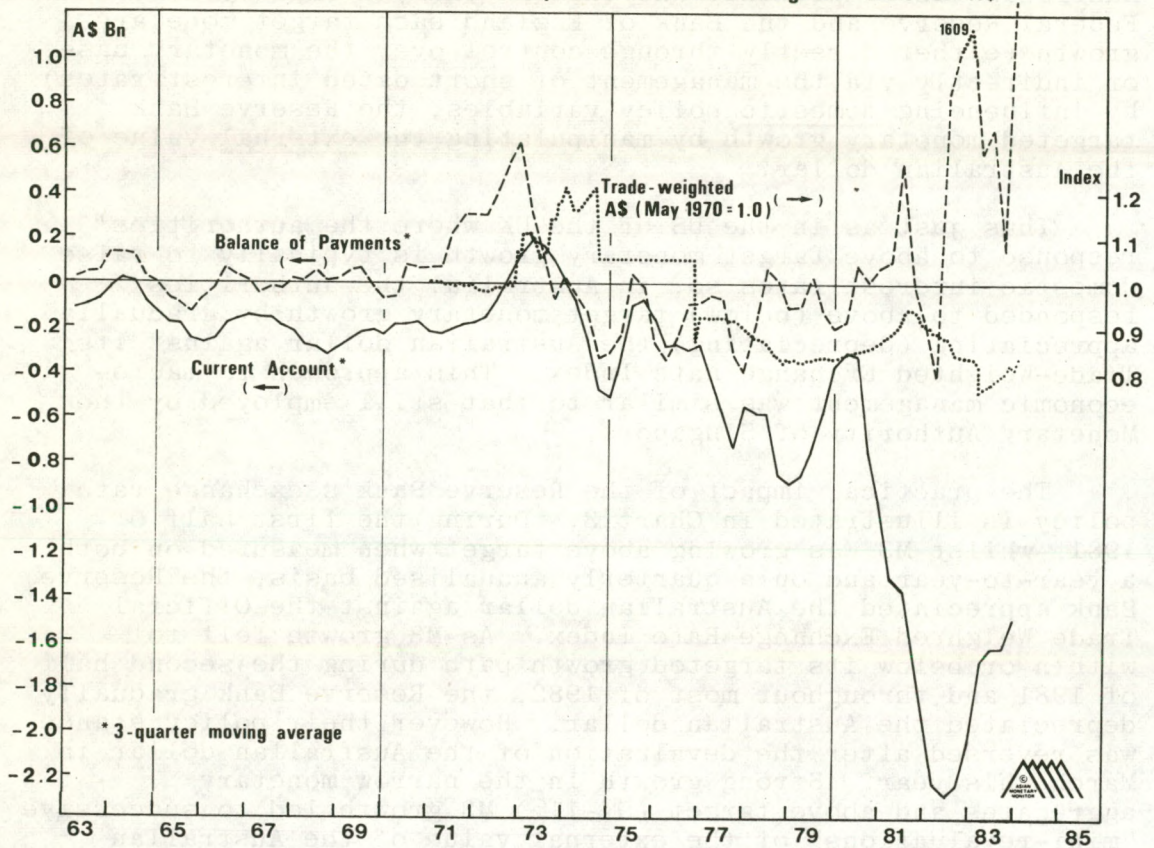
The practical impact of the Reserve Bank's exchange rate policy is illustrated in Chart 3. During the first half of 1981, whilst M3 was growing above target when measured on both a year-to-year and on a quarterly annualised basis, the Reserve Bank appreciated the Australian dollar against the Official Trade Weighted Exchange Rate Index. As M3 growth fell to within or below its targeted growth path during the second half of 1981 and throughout most of 1982, the Reserve Bank gradually depreciated the Australian dollar. However their policy stance was reversed after the devaluation of the Australian dollar in March this year. Strong growth in the narrow monetary aggregates and above target (9%-11%) M3 growth led to successive "mini-revaluations" of the external value of the Australian dollar.

It has been commonly suggested that it is the continuation of large private capital inflows into Australia, at a time when the current account deficit is undergoing a cyclical contraction, which has been the main force behind the stronger Australian dollar this year. This suggestion, however, is not strictly true, as may be demonstrated if we consider the interaction of monetary, balance of payments and exchange rate trends throughout 1982. Last year Australia enjoyed a balance of payments surplus of A\$4,900 million, a considerable improvement from the deficit of A\$150 million recorded during 1981 (see Chart 4). In spite of the sharply higher external surplus however, the Australian dollar was depreciated from 90.5 against its Trade-Weighted Exchange Rate Index, to 83.4 over the course of the year. This occurred, in terms of the analysis presented here, as M1 growth plunged and M3 growth fell relative to its target (refer to Chart 3). The expansionary monetary impact of the balance of payments surplus was more than offset by a large decline in the domestic components of monetary growth. The implications of this analysis strongly suggest that, under the previous managed exchange rate system, it was the growth of M3 relative to target which was the main influence on the cyclical trend in the Australian dollar, and not the position of the overall balance of payments per se.

AUSTRALIA

Chart 4

Current Account, Balance of Payments and Trade-weighted Value of A\$



In recent months, speculative activity on the foreign exchanges exacerbated the Reserve Bank's difficulties in monetary control. The Reserve Bank had proved reluctant to appreciate the Australian dollar to levels which would choke off the surpluses on the balance of payments, and M3 growth continued to rise above its target growth path. Under the Australian authorities' previous exchange rate management procedures, this enhanced the likelihood of a subsequent official appreciation of the Australian dollar. Foreign exchange market participants quickly came to realise this, and capitalised upon it by buying Australian dollar deposits. These transactions implied a rise in recorded private capital inflows to Australia, a larger overall balance of payments surplus and the potential for increased domestic monetary growth as a result of faster growth in the foreign (or balance of payments) component of the monetary base.

This process came to a climax in November and early December. Australia recorded an overall balance of payments surplus of A\$1,755 million in October and November, sharply higher than the average monthly surpluses of A\$150 million recorded in the second and third quarters of this year, and its International Reserve holdings leapt nearly 14% to A\$12,000 million. The Australian dollar was appreciated strongly on the foreign exchanges, but the authorities' action came too late to prevent M1 from rising nearly 5% over the period or M3 growth (13.4% in the year to November) from accelerating to its most rapid rate in nearly seven years. Short interest rates fell sharply, with three month Treasury Bill yields declining almost to 8% early in December, after 11% in August.

Above target monetary growth is symptomatic of the authorities' reluctance to appreciate the Australian dollar to levels sufficient to reduce the overall balance of payments surplus. It appears, in fact, that the Australian authorities were trying to achieve two targets - a desired level of monetary growth and a desired trading range for the exchange rate. In the event, the authorities failed on both counts as M3 growth continued above target and the Reserve Bank was ultimately forced to appreciate the Australian dollar to higher levels than it had originally intended. This illustrates the desirability of pursuing either a price rule (a pegged exchange rate) or a quantity rule (monetary targets), and not switching between the two, as the Reserve Bank did, in an attempt to accomplish both. It is far preferable given the authorities' ultimate desire to control M3, from the standpoint of domestic monetary policy that the authorities have implemented a floating exchange rate regime. Such a policy will greatly reduce the impact of changes in Australia's overall balance of payments position on local monetary growth, and will therefore remove the major impediment to direct, discretionary, control over the growth of the monetary base and the broader monetary aggregates.

The cyclical outlook for the Australian dollar will now depend very much on how the Reserve Bank chooses to use its newly acquired discretion in the formulation of domestic monetary policy. Prior to the float, the operation of the managed exchange rate system implied that cyclical strength in the Australian dollar was a symptom of above target monetary growth. Now however, any continuation of the relaxed monetary conditions currently evident in Australia would surely undermine the Australian dollar's recent strength against other major currencies. If the "easy" monetary environment is prolonged into the second half of 1984, this will undoubtedly prove to be the precursor of a strong recovery in the domestic economy and a deterioration in both Australia's current account and in inflationary expectations.

FORECAST: The strength of the Australian dollar between April and December of this year can be attributed mainly to the Australian authorities' policy of using the exchange rate as its principal instrument of monetary control. The Reserve Bank's response to above-target monetary growth was to raise the external price of money in order to attempt to reduce Australia's balance of payments surplus.

This policy has now been abandoned. Cyclical strength in the Australian dollar will no longer be a symptom of above-target monetary growth, as was the case whilst the exchange rate was the key instrument of monetary control. The prospective strength of the Australian dollar should now be assessed in exactly the same way as any other freely floating currency. Providing private capital inflows to Australia remain at close to the levels of mid-summer, a continued improvement in Australia's trade account - where exports have risen approximately 25% over the past year in comparison to import growth of 5%-10% - is likely to ensure that the overall balance of payments remains in surplus over the next several months. This should provide fundamental support for the Australian dollar during the first half of 1984.

However, unless the Reserve Bank acts to curtail domestic monetary growth, the Australian dollar's recent strength is likely to be swiftly eroded. The sharp recovery in real growth in Australia during the third quarter - where real non-farm GDP surged at an annual pace of nearly 10% - is proof enough of the effective "ease" of current monetary policy. If the Reserve Bank persists with its current stance into the second half of 1984 there is no reason why the Australian economy should not continue to experience a very strong cyclical rise in real growth. This would quickly lead to a revival in import demand and inflationary expectations, and the Australian dollar would likely once again prove to be very vulnerable to any reduction in private capital inflows.

THE STABILISATION OF THE HONG KONG DOLLAR

INTRODUCTION

At noon on Saturday October 15th, 1983 Hong Kong's Financial Secretary Sir John Bremridge announced a unique scheme to stabilise the value of the Hong Kong dollar. His announcement came exactly three weeks from Black Saturday, September 24th when the value of the Hong Kong dollar had plunged in a free fall, sending the US\$ to a price of HK\$9.55 on the local foreign exchange market, and nearly ten years from the ill-fated decision of November 1974 to float the Hong Kong dollar from its parity of HK\$5.65 to the US dollar. The new scheme, which was to be implemented from the opening of the foreign exchange markets on Monday October 17th, would operate by restoring a fixed rate against the US\$ for the issue and redemption of Certificates of Indebtedness, equivalent to Hong Kong dollar banknotes, this time at HK\$7.80 per US dollar.

After a decade of drift the Hong Kong dollar had at last been rescued.

In large measure the scheme adopted by the Hong Kong Government puts into practice the proposals set out in Scheme 2B of the September-October issue of Asian Monetary Monitor ("How to Rescue the Hong Kong Dollar: Three Practical Proposals"). There are a few minor points of difference, but the fundamental principles set out in that paper have been substantially incorporated in the new scheme. This article analyses the collapse of the Hong Kong dollar in the period up to September 24th (Section 1), describes some of the events of the next three weeks during which the stabilisation plan was evolved (Section 2), and outlines the basic theoretical elements of the new scheme (Section 3). Finally, we provide an account of the detailed institutional arrangements of the stabilisation plan, and note the differences between the actual plan adopted and the original AMM proposals (Section 4).

SECTION 1

A MONETARY ANALYSIS OF THE COLLAPSE OF THE HONG KONG DOLLAR

Under the barrage of incessant daily propaganda from the communist Chinese press - which circulates freely in Hong Kong - there was mounting anxiety in the colony during September about the future of the territory after 1997. These anxieties could have been largely contained were it not for the fact that Hong Kong's monetary system suffered from certain basic defects as a result of technical changes made in July 1972 concerning the issue of banknotes in Hong Kong, which ultimately led to the floating of the Hong Kong dollar in November 1974.

(a) An Inherently Unstable System

The net result of these defects was that in Hong Kong's unorthodox monetary system neither the price of money nor the quantity of money was controlled. Technically, Hong Kong's monetary arrangements constituted an indeterminate, metastable equilibrium system. This meant that for any given level of money supply and prices in Hong Kong, the exchange rate would adjust to that price level; alternatively, given any level of the exchange rate, money supply and domestic prices would adjust to that exchange rate.

Since the world abandoned fixed exchange rates (i.e. fixing the price of money) around 1973 most major industrial countries (USA, Japan, UK and West Germany) have moved, to a greater or lesser extent, to control the quantity of money (i.e. the money supply). These countries have been able to do this because they have central banks which can supply or withdraw base money (or high powered money) on a discretionary basis. (Base money or high-powered money consists of the monetary liabilities of the central bank i.e. notes and coins plus commercial banks' deposits at the central bank. In practice it is only banks' deposits which can be adjusted in a discretionary manner by the central bank.)

In the case of Hong Kong, the decision was taken in November 1974 to float the currency (i.e. to vary the price of money) but no corresponding provisions were made to control the quantity of money. Although official government statements were not couched in these terms, the reason that the Hong Kong government could not control the money supply was that the banks did not hold deposits with the monetary authorities, and therefore the authorities were not in a position to supply or withdraw base money in a discretionary fashion.

Instead, Hong Kong had a form of Colonial Currency Board called the Exchange Fund, whose main function was - and is - the issue of so-called Certificates of Indebtedness which authorise the two note-issuing banks to issue banknotes, but the issue and redemption of banknotes could not be done on a discretionary basis. In sum, neither the money supply nor the exchange rate had been controlled. Consequently there was no fixed point within the system around which money, prices or the foreign exchange rate could find equilibrium. The only "prices" over which the monetary authorities exercised any influence were the interest rates on retail deposits at licensed banks and the associated Best Lending Rate (BLR) of the licensed banks. Until August 1983 Hong Kong had been lucky: as long as expectations about the future were buoyant and therefore perceived real rates of return on capital were at "normal" levels, the banks' interest rate cartel had been sufficient to keep the Hong Kong dollar exchange rate reasonably stable. (N.B. It had not, however, been capable of keeping the money supply stable - see AMM Vol. 6 No. 6 pp.18-26).

(b) Failure of the "Interest Rate Weapon"

However, under the barrage of Peking propaganda on the one hand, and given the British confidentiality over the talks in Peking and the inevitably slow progress of those talks on the other, Hong Kong people's hopes about the future were beginning to crumble. In the money markets, this translated itself into lower perceived real returns on businesses and property in Hong Kong, stimulating a consequent capital outflow. But in practical terms businesses and property could not be exported; they first had to be sold, and then the Hong Kong dollar proceeds in turn had to be sold on the foreign exchange market. Since the only way people in Hong Kong could export capital under the existing floating exchange rate system was to sell Hong Kong dollars to somebody else, the Hong Kong dollar was driven down on the foreign exchange markets, and domestic prices began to rise as the velocity of circulation increased and the exchange rate declined.

This was the process which resulted in the collapse of the foreign exchange value of the Hong Kong dollar in September, and a situation of near panic in Hong Kong as people started to hoard rice, cooking oil, toilet paper and other basic essentials ahead of the inevitable price inflation.

With capital fleeing Hong Kong in search of higher returns elsewhere, surely this was the moment to bring the "interest rate weapon" to bear. The rate structure had not been altered since late July (when rates were lowered by 1 percent), and the currency

had ended the month at HK\$7.31 per US dollar. By September 7th the exchange rate had fallen to HK\$7.74 and the Hong Kong Association of Banks agreed to raise deposit interest rates by 1 1/2% percentage points. Simultaneously the Prime Lending Rate was raised to 13 percent.

Initially there was some impact, and the currency closed at \$7.67 on September 10th, but by September 13th it had started to fall again, closing at \$7.78. On September 17th the HK\$ crashed through the psychological \$8.00 level, hitting \$8.40 two days later. By the time the bankers met again on Sept. 19th they were increasingly reluctant to take all the strain on interest rates, and decided not to raise them. Perhaps, in part, they sensed the futility of another rate hike; perhaps, in part, they felt that if they were to lose loan business by raising interest rates, the government should at least provide more intervention to support the exchange rate as a quid pro quo.

On September 22nd and 23rd the Fourth Round of Sino-British talks were held in Peking. On September 23rd the HK\$ suffered its sharpest fall to date, plunging to \$8.83 against the US\$ following the release of a bare one sentence joint statement in Peking which merely said the two sides "held further talks on the question of Hong Kong ... and the fifth round will be held in Beijing on October 19 and 20".

On Saturday, September 24th the Hong Kong dollar went into an uncontrolled tailspin. In the words of the South China Morning Post (on Sunday, September 25th), "The Hong Kong dollar's free-fall continued on the foreign exchange markets yesterday, dropping to yet another all-time low against the American dollar at \$9.45/55, and triggering a huge surge in the local gold price.

"Following hard on the heels of yet another non-statement at the conclusion of the latest round of Sino-British talks on Hong Kong's future it can leave absolutely no doubts as to the political nature of the Colony's fast dwindling exchange rate.

"Trade was thin and one-way with much of the demand for US dollar emanating from gold merchants using US dollars as the intermediate currency on almost panic buying of taels at gold shops throughout the territory.

"The local gold price consequently closed sharply higher at \$4,705 a tael - significantly trading at premium on the international bullion price of US\$418/419 an ounce despite the modest discount that has ruled since the beginning of the year - after touching yet another 3 1/2-year high earlier in the day at \$4,750.

"This \$409 spurt is the sharpest single day's gain in the tael price since January 1980.

"The Hong Kong dollar's slump, meanwhile, was aggravated by a marked reluctance on the part of US dollar holders to sell at any price, in addition to some minor commercial demand for greenbacks.

"The local unit opened at \$8.70/80 vis-a-vis the American dollar, compared with the late \$8.80/90 ruling on Friday, and sank as effortlessly through the psychological \$9 barrier as it did through the \$8 mark last Saturday.

"The decline and fall of the local currency continued unabated until the local forex markets closed at 12.30 pm, by which time the Hong Kong dollar was \$9.45/55 against its American counterpart.

"Spreads remained at banana republic levels all morning, blowing out at one stage to an incredible 3,000 points with a Hongkong and Shanghai Bank quote at \$9.20/50.

"The dollar's vertiginous plunge was manifest in a massive 4.5 point slump in the trade-weighted index to another nadir of 57.2.

"Against a backdrop of a plummeting exchange rate now clearly out of control, the Hong Kong Association of Banks announced after its usual Saturday morning meeting that it had decided "to maintain the present interest rate structure unchanged".

The interest rate weapon had failed.

(c) Why the Interest Rate Weapon failed

Why was it, fundamentally, that raising interest rates had proved futile in the face of this crisis?

After all, just two years earlier the government had placed its faith in the "interest rate weapon", enshrining the Interest Rate Agreement of the Exchange Banks Association in an elaborate legal and quasi-legal structure comprising a new 3-tier banking system (from January 1981), and a supporting system of licensing or registration requirements, reporting procedures, and channels for consultation with the government. The Interest Rate Agreement of the licensed banks was given pride of place in the new banking framework, and it was reinforced by the prohibition on registered deposit-taking companies (DTCs) soliciting deposits of under HK\$50,000 and of less than 3-months maturity, and the prohibition on licensed DTCs soliciting deposits of less than HK\$500,000 for any maturity. This compartmentalisation of the deposit market was supposed to ensure that while free market rates might hold sway in some sectors of the deposit market, there would be one area in which the government, in consultation with the licensed banks through the newly-created Hong Kong Association of Banks (HKAB), would have a reasonably firm grip on interest rates, and hence on bank credit creation and thus supposedly on the money supply.

Sadly for Hong Kong this elaborate edifice was critically flawed in three respects. In the first place it made the classic error of confusing the price of money with the price of credit by explicitly suggesting that interest rates were the price of money and hence an effective lever through which the quantity of money could be controlled. In fact the price or purchasing power of a nominal unit of money is what has to be given up to obtain it (e.g. a certain amount of goods and services, or a certain amount of foreign exchange). Interest rates, which are the price of credit, are what has to be paid to rent money for a specific period.

In common with the experience of other countries, the use of interest rates as the basic tool of policy in Hong Kong from the early 1970s onwards had contributed significantly to widening the amplitude of Hong Kong's business cycle fluctuations by encouraging periods of excess bank credit creation and excess money growth alternating with periods of credit restriction and monetary contraction. The first episode of excess money growth was in 1972-73, just after the change in currency-issuing procedure in July 1972, followed by a collapse of money and credit growth in 1973-74; a second episode of excess money and credit growth occurred in 1978-81, and a second episode of contraction in 1982-83. (See AMM Vol. 6 No. 6 pp.18-26 for the details of the theory underlying this proposition).

A second basic problem with using interest rates as the tool of monetary policy began to be evident in September 1983. Growing scepticism at the possibility of a favourable outcome from the Peking talks was leading to lower perceived rates of return on capital in Hong Kong over the long term and hence to a capital outflow. Consequently it would have required an extraordinarily high level of interest rates in the short term to

make the perceived yields on capital in Hong Kong equal to the perceived yields on capital elsewhere. As neither the banks nor the authorities were willing to raise interest rates to such a level, the exchange rate inevitably gave way under the pressure of Hong Kong dollar selling.

Thus the interest rate weapon not only failed as a tool of monetary policy in normal times due to the fundamental misconception that interest rates were the "price" of money, but the interest rate weapon also failed in the moment of crisis in September 1983 because there was no level to which short term interest rates could reasonably be raised which would compensate for the lower rates of return on capital in Hong Kong in the long term which the supposed outcome of the Sino-British talks in Peking were believed to imply.

In addition the Hong Kong dollar crisis of September 1983 high-lighted a third fundamental problem - the problem of the distinction between nominal interest rates and real interest rates. For while central banks and governments may be able temporarily to fix a limited number of nominal interest rates, they have no such ability to control real interest rates i.e. the real rates of return on the whole range of capital goods including land and buildings, industrial plant and machinery, durable goods such as vehicles, electrical appliances and so on. Yet it was the change in Hong Kong people's perception about the expected long term real rates of return on capital - especially businesses and properties in Hong Kong - which, in our hypothesis, precipitated the currency crisis. As people began to lose confidence in the outcome of the Peking talks over Hong Kong's future, real rates of return on capital or other assets outside Hong Kong began to be perceived as more attractive than returns inside the territory, and consequently capital in the form of buildings, businesses, and monetary assets were being sold to enable their owners to switch to the higher perceived real rates of return available abroad.

In effect the prices of capital assets in Hong Kong were being driven down to levels necessary to equate yields in Hong Kong with yields overseas. Given the fact that Hong Kong had a floating exchange rate, and, under the existing monetary framework, no workable mechanism for supporting the exchange rate, the currency could theoretically have been driven to the point where Hong Kong dollars were virtually valueless as residents attempted to export capital through the foreign exchange market. In such circumstances it is hard to conceive what the government could have done with the available tools to raise nominal interest rates in Hong Kong sufficiently to offset the abrupt change in the public's perception of real rates in Hong Kong versus real rates abroad.

With the failure of the interest rate weapon the monetary standard, the value of the local unit of account, collapsed. The Hong Kong dollar, in short, was only worth what people were prepared to pay for it, and in September 1983 that amount was plummeting. By September 24th the value of a Hong Kong dollar had fallen to only just above a dime or 10 cents in US currency (HK\$9.55 per US\$1.00). The desperate problem facing the monetary authorities was how to stop the slide in the short term - with stopgap measures if necessary - and, in the longer term, how to restore Hong Kong's monetary standard to a sound and secure basis which would survive in the critical years up to 1997 and possibly beyond.

SECTION 2

A STOPGAP ANNOUNCEMENT

Faced with a flight from the currency and a crisis of public confidence in the ability of the monetary authorities to protect people's money, the government urgently needed a concrete, workable plan. To be successful any such plan would require three characteristics: it would need to be theoretically sound, operationally feasible in Hong Kong's particular circumstances, and politically acceptable in Hong Kong, London and Peking.

With the Financial Secretary (Hong Kong's equivalent of Secretary of the Treasury or Minister of Finance and Governor of the Central Bank) away from the colony attending the Commonwealth Finance Minister's Conference in Trinidad and scheduled to go to Washington the following week for the annual meetings of the IMF and World Bank, there was no possibility of implementing a comprehensive currency stabilisation package involving fundamental monetary and political issues over the weekend of September 24-25th. But in an atmosphere of mounting tension and anxiety government officials were determined that something meaningful needed to be said or done to arrest the currency slide, restore public confidence and provide some breathing space for a plan to be developed.

The recognition that such a plan was needed represented a major turning point - the official view up until this time having been that nothing was fundamentally wrong with the floating exchange rate system and therefore no serious reform was required.

Accordingly an emergency meeting was called for 11.00 a.m. on Sunday, September 25th with a view to discussing the available options. Those present included senior government officials from the Monetary Affairs Branch, the Commissioner for Banking, representatives from the two note-issuing banks - the Hongkong and Shanghai Bank and the Chartered Bank - government economists, and the editor of AMM.

Following that meeting, which lasted until late afternoon, the Acting Financial Secretary who was also the Secretary for Monetary Affairs, released the following announcement to the press:

HONG KONG GOVERNMENT STATEMENT ISSUED SEPTEMBER 25TH 1983

As a result of the recent unwarranted depreciation of the local currency the Acting Financial Secretary Mr. Douglas Blye has been in consultation throughout the week-end with the note-issuing banks and other advisers.

Various proposals have been considered. A basic pre-requisite of all of these proposals was full convertibility of the currency.

One proposal which is being actively developed involves a substantial revision of the mechanics for issuing and redeeming Certificates of Indebtedness to the note-issuing banks in such a way as to produce an exchange rate which would more accurately reflect the fundamental strength of the economy. The proposal will mean the assumption by the Exchange Fund of a more significant role in the exchange rate determination mechanism.

In the meantime the Exchange Fund retains its existing capability to intervene in the foreign exchange and money markets.

The following day was Monday September 26th, and most foreign exchange dealers were at their desks especially early. For the most part they were baffled by the Acting Financial Secretary's statement. In effect he had promised convertibility, but failed to deliver. No price was mentioned, and many people in any case did not understand how there could be a connection between the domestic note issue process referred to in the press statement and the daily commercial foreign exchange rate which, as the previous few days had so dramatically shown, was entirely determined by the free market. Accordingly there was immense uncertainty about the immediate outlook and this was duly reflected in the huge spreads quoted by dealers. Prior to market opening some dealers were quoting HK\$8.00-9.00 for the US dollar - a spread of 10,000 basis points.

When the market opened at 9.00 a.m. spreads narrowed to between 7,000 and 5,000 basis points, but volume was minimal and some traders simply were not prepared to deal at all.

At 10.00 a.m. the Hong Kong Association of Banks announced a hike in deposit interest rates of 3 percentage points, and the two leading banks raised their best or prime lending rate to 16%. At this time the HK\$ was being quoted at 7.90-8.40. However, the foreign exchange market was disappointed by the rise in rates, since dealers had, perhaps optimistically, expected some more far-reaching package of monetary measures, not simply the same ineffective instruments. The effect of the 3-percentage point hike in rates lasted about ten minutes, and the exchange rate then dropped back to the 8.20-8.60 range. Combined intervention by the Government and the 2 note-issuing banks seemed to have little impact. Towards the end of the day spreads narrowed a little, and the HK\$ closed at 8.32-42, in the words of the South China Morning Post "with Government support for the flagging currency manifest".

The next day, Tuesday September 27th spreads were generally narrower, though still at abnormally high levels, with the prevailing uncertainty being reflected in wider swap costs for US dollars. However the main event of the day occurred after market closing when the Legislative Council met in an emergency 15-minute session during which a bill to empower the government to take over the Hang Lung Bank, the Hang Lung Bank (Acquisition) Bill 1983 was taken through the necessary three readings. The Hang Lung Bank, a local bank with 28 branches, had been the subject of a bank run in September 1982, and had been known to be having liquidity difficulties for some time. The Financial Secretary - who had arrived back in Hong Kong on Monday evening - said the bank had reported to the Commissioner of Banking that it was unable to meet in full its liabilities to the Clearing House in respect of cheques drawn by its customers. The Chartered Bank was not prepared to cover a resulting HK\$50 million overdraft on Hang Lung Bank's clearing account with it, and the government felt obliged to step in to cover the obligation at the Chartered Bank and to prevent a more serious situation developing.

As a matter of record this was the first time that the Exchange Fund had been mobilised in the capacity of lender of last resort to a bank in the private sector. Usually in the past a Hong Kong bank in difficulties would have been left to find a private sector rescuer or buyer.

On this occasion, however, the Financial Secretary stated that "The Government believes it would be unacceptable, both domestically and internationally, to allow this bank to fail, which would involve considerable loss to depositors the depositors' interests override those of shareholder".

In the subsequent days, activity on the banking front, on the currency front, and in other departments of government was feverish. The Secretary for Monetary Affairs took over as chairman of the Hang Lung Bank. Mr. Richard Luce the British Foreign Office Minister responsible for Hong Kong affairs was on a busy 5-day visit and left on

A DEALER'S DIARY OF EXCHANGE RATES AND SPREADS FOLLOWING THE STOPGAP ANNOUNCEMENT

September 26 - October 7, 1983

Monday, 26th Sept.	Time	Rate	
	8.45 am	9.00 offer only 8.30 - 8.80	Market feeling was that the government may be about to take action to squeeze speculators.
	8.50 am	8.10 - 8.60 8.00 - 8.50 8.00 - 8.30	
	9.05 am	8.20 - 8.50	
	9.20 am	8.40 - 8.70 8.35 - 8.85	
	9.23 am	8.20 - 8.70	
	9.40 am	8.10 - 8.60	HK Bank and government rumoured to be buying. Demand from individuals for US dollars.
	10.05 am	7.90 - 8.40	
	10.06 am	8.15 - 8.50	
	10.08 am	8.00 - 8.50	
	10.30 am	8.10 - 8.60	
	10.45 am	7.80 - 8.30	HKAB Raise Prime by 3% to 16%.
		7.90 - 8.40	
	10.50 am	8.20 - 8.60	Market took the prime hike bearishly, as it was expecting some form of monetary package, not use of the same monetary instruments.
	11.18 am	8.10 - 8.60	
	12.30 pm	8.30 - 8.60	
	2.30 pm	8.45 - 8.65	
	2.35 pm	8.30 - 8.50	
	3.42 pm	8.35 - 8.50	Practically no trading at this time.
	Close	8.45 - 8.55	

Mid-rates

	High	Low	Open	Close	Average Spread
Tuesday, 27th Sept.	8.10	8.48	8.35	8.15	2,000 basis points
Wednesday, 28th Sept.	8.08	8.42	8.35	8.15	1,000 basis points
Thursday, 29th Sept.	8.13	8.32	8.20	8.18	1,000 basis points
Friday, 30th Sept.	8.03	8.24	8.15	8.13	500 basis points
Monday, 3rd Oct.	8.13	8.92	8.20	8.80	1,000 basis points
Tuesday, 4th Oct.	8.43	8.90	8.75	8.62	500 basis points
Wednesday, 5th Oct.	8.28	8.73	8.35	8.68	1,000 basis points
Thursday, 6th Oct.	8.52	8.73	8.60	8.62	500 basis points
Friday, 7th Oct.	8.40	8.70	8.60	8.45	500 basis points

Wednesday September 28th. On Sunday night George Tan, chairman of the high-flying Carrian property group, was arrested. His companies, besieged by creditors, reportedly owed in excess of HK\$8 billion to creditors. On the following Wednesday October 5th the Governor Sir Edward Youde gave his annual "state of the union" policy address in the Legislative Council, but he made no mention of an impending solution to the HK\$ crisis. That evening he and the Unofficial members of the Executive Council (i.e. appointees from outside the civil service) flew to London for consultations with the Prime Minister, the Foreign Minister and the Chancellor of the Exchequer. Meanwhile the Hong Kong dollar which had continued to trade in the 8.40-8.60 range, slipped back to 8.80 and on October 4th the Hang Seng Index of share prices fell below 700 for the first time in the year.

In the week beginning Monday October 3rd Charles Goodhart from the Bank of England and David Peretz from the Treasury arrived in Hong Kong to advise the Financial Secretary on the best course of action. By the end of that week it seemed the broad outlines of a monetary package had been decided on for the advisers from the Bank of England and Treasury returned home. There only remained the institutional and administrative details to be finalised.

The Governor returned from London over the weekend of October 8-9th. A press statement from Downing Street said that he had had discussions with the Chancellor of the Exchequer, but that the Chancellor had given no currency advice. It was clear from this statement that the monetary package necessary to solve the Hong Kong currency crisis was to be announced by the Hong Kong government alone, and that it was unlikely to involve fixing the Hong Kong dollar to sterling.

These were the events on the public record as participants in the foreign exchange and money markets waited for the announcement of the government's package.

SECTION 3

THEORETICAL ELEMENTS OF THE STABILISATION PLAN

At this stage it is necessary to digress from the narrative of the events to discuss some of the theoretical issues underlying the choices facing the monetary authorities at this critical moment. Doubtless few of the dramatis personae - mainly government officials - would have considered the decisions they were taking from the theoretical standpoint that will be outlined below, but irrespective of any rationalisation given at the time for the final outcome, to any student of monetary history or comparative monetary systems the intellectual framework within which official decisions had to be made was pre-determined.

For the long term the important problem was to select and define a monetary standard for Hong Kong. For the short term there was the problem of transition from existing arrangements to any new system; whether to adopt full or partial convertibility, the optimum currency on which to base Hong Kong's new monetary standard, and the precise level to be chosen for the new fixed exchange rate.

(a) The Choice of Monetary Standard

The properties of an optimal monetary standard are (i) that it should cost the society a minimal amount of resources to produce, thereby maximising the amount of resources available for other, non-monetary purposes, and (ii) that it should perform the essential functions of money, acting both as an efficient medium of exchange and as a stable store of value.

From the earliest days of the British occupation of Hong Kong, silver was the de facto commodity standard although it was not until 1869 that the colonial government officially acknowledged the use of silver as legal tender. Since silver was a metal with other non-monetary uses, it cost the community a substantial amount to maintain the physical commodity as money. Consequently after the appearance of banks in Hong Kong, representative paper money began to be issued in exchange for and circulate in place of silver coins and bullion so that gradually silver ceased to be the day-to-day medium of circulation. However, it was not silver's properties as a physical commodity which ultimately caused its demise as the monetary standard of China and Hong Kong. It was as a stable store of value that silver ultimately failed, for when the US Treasury quadrupled the US dollar price of silver in 1934 (from 25 cents to \$1.29 per oz.), the external exchange rate of China and Hong Kong was in effect revalued upward by some 400%. This produced a drastic deflation as silver poured out and the local money supplies contracted. In response, China and Hong Kong abandoned the silver standard, with China nominally adopting a foreign exchange standard but in reality going on to a pure paper standard (which ultimately degenerated into hyperinflation), and Hong Kong going on to the sterling exchange standard.

The mechanics of shifting from a commodity (silver) standard to a foreign currency (sterling) exchange standard were surprisingly simple. Under the silver standard the 3 note-issuing banks had held silver coin or bullion in their vaults against every banknote issued. In 1935 the government took over the silver reserves of the banks, issuing the banks in exchange with "Certificates of Indebtedness" representing indebtedness of a new government institution, the Exchange Fund, to the note-issuing banks. The banks now held the non-interest bearing Certificates of Indebtedness (or CIs), which were denominated in HK\$, as assets corresponding to their HK\$ note issue instead of silver. The Exchange Fund in turn sold the silver and invested the proceeds in sterling securities, creating for the government a steady stream of income or seignorage which the banks had previously not enjoyed. In sum the government had captured most of the benefits of the note issue (i.e. the seignorage), but avoided the costs by effectively sub-contracting the design, engraving and printing of the notes themselves to the three note-issuing banks.

From 1935 onwards the banks were required to pay sterling to the Exchange Fund for new Certificates of Indebtedness (CIs), which authorised the bank in question to issue new Hong Kong dollar bank-notes. The CIs were denominated in Hong Kong dollars, and priced at 1s.3d. per Hong Kong dollar.

By defining the Hong Kong dollar in sterling and allowing free convertibility (i.e. issue and redemption at fixed price) by the note-issuing banks, the Hong Kong government was in effect selecting sterling as its monetary standard. Also, by transferring from the silver standard to this type of fiat money standard the government secured for the community the two benefits of a desirable monetary standard: (a) that production and transaction costs were minimised, and (b) that, because the value of sterling could be expected to be reasonably stable over time, the value of the Hong Kong dollar (expressed in terms of general purchasing power) could also be expected to remain stable.

As explained in previous issues of AMM, in 1972 the Hong Kong dollar was unhitched from sterling and pegged to, or more strictly defined in terms of, the US dollar at HK\$5.65 per US\$1.00. In principle the Hong Kong dollar ought to have remained as steady against the US dollar as it had traditionally been against sterling. However, partly as a result of certain guarantees which the Hong Kong authorities had made to the note-issuing banks in connection with the US\$ value of their sterling assets and the resultant costs this was imposing on the Exchange Fund, and partly as a result of departing from the practice of accepting exclusively foreign currency at a fixed price

against issues of Certificates of Indebtedness, the basic soundness of Hong Kong's monetary standard was eroded.

Initially these changes to the monetary standard were concealed by the sharp deflation which Hong Kong had undergone in 1973-74, and the consequent strength of the Hong Kong dollar after the currency was floated in November 1974. However, as the subsequent economic recovery developed the new forces regulating the rate of monetary expansion gradually got the upper hand and from 1977 onwards the currency began to lose value on the foreign exchange market. From time to time the raising of interest rates by the local bank cartel successfully stopped the slide, but this mechanism gradually became less effective, and in any case could only hope to succeed so long as returns on assets in Hong Kong were perceived to be "normal" and nominal interest rates were kept roughly in line with interest rates abroad, particularly in the U.S.A. However, the political events of 1982-83 finally destroyed that "normality", precipitating the collapse of the Hong Kong dollar in September 1983.

A basic problem in restoring a sound monetary standard in Hong Kong in September/October 1983 was the lack of familiarity, among those closely involved, with the mechanisms and strengths of earlier monetary standards. Those involved in the discussions at a technical level had either been in junior positions in the pre-1972 era (if they had been in Hong Kong), or they had come from monetary systems with central banks which had in the past decade moved away from fixed exchange rates towards discretionary control of the money supply. Accordingly there was little institutional memory of the old system, and even among those who were familiar with it there was a tendency to believe that somehow the existence of the Sterling Area, the prevalence of foreign exchange controls, and the generally fixed parities of the Bretton Woods system were all somehow necessary features of the old colonial currency system. Even a modicum of knowledge of monetary systems in the 19th century or in the pre-World War II period would have shown these beliefs to have been false, but such details of monetary theory and history were simply not part of the common store of knowledge or experience.

Consequently, although the switch from a floating exchange rate system to the convertible banknote system which was finally adopted turned out to be remarkably simple and relatively painless, the intellectual leap required to recognise the deficiencies of the prevailing status quo and to be willing to accept the "new" system was probably a far greater obstacle to the introduction of the new scheme than the practical difficulties of implementing any operational aspects of the new scheme. Understandably, Hong Kong's government officials would have been reluctant to take such a leap in the dark.

The scheme that was finally chosen is reasonably satisfactory when measured against the criteria for an optimal monetary standard. First, as a fiat money system it requires a minimal amount of resources, and yet the interest earned on the foreign currency assets which correspond to the issue of currency notes is retained as seignorage by the government. Second, the HK\$ currency continues to act as an efficient medium of exchange, and, provided that US monetary policy is conducted in a non-inflationary manner, the HK\$ will remain a stable store of value.

In retrospect it is relatively simple to see the choices Hong Kong faced in selecting a monetary standard. However, as in many scientific or theoretical problems the human and political aspects of the choice no doubt assumed a seemingly dominant role at the time. But at a theoretical level the truth was that the authorities had very little choice: they had to select a monetary standard which was compatible with an automatic or non-discretionary monetary system and this effectively meant they had to choose some foreign currency (or currencies) as the monetary standard for Hong Kong. The only areas of discretion concerned the degree of convertibility, the choice of currency (or currencies), and the actual level of the exchange rate.

(b) Partial Convertibility or Full Convertibility

An awkward problem for the authorities throughout the HK\$ crisis was the widely held view that the Hong Kong government had virtually no capability to fix the exchange rate at any level. In no small degree the government had itself engendered such doubts, for in the years preceding the Hong Kong dollar crisis of September 1983 numerous senior government officials had repeatedly stated that it was technically impossible or at least undesirable in a world of floating exchange rates to fix the value of the Hong Kong dollar to any other currency. This assertion was repeated on several occasions as the slide of the Hong Kong dollar accelerated through the summer.

Given the pervasive view that fixing the exchange rate was not feasible, it was not unnatural for government officials to be concerned that if a rate for the Hong Kong dollar was guaranteed, it might either precipitate a massive conversion of Hong Kong dollar deposits into foreign currency, and/or it would somehow drain the official reserves and even require temporary facilities from the Bank of England or elsewhere. If banks were suddenly to see their HK\$ deposits converted to foreign currency on a large scale there was a feeling that this would set off an intense credit squeeze in the Hong Kong dollar money markets. A frequently repeated fear was that this might force banks to liquidate loans, leading to a multiple contraction of credit.

There were two possible solutions to these anxieties: either (a) to adopt a stabilisation plan offering full convertibility which was so sweeping in its extent and so reassuring to the public that there could be no possible doubt of the government's intention to fix the exchange rate, or (b) strictly to limit the government's actions to guaranteeing the currency component of the money supply - in effect only offering partial convertibility - and to force the burden of economic adjustment to the new rate directly on to the private sector.

The first plan, also put forward by the editor of AMM, would incidentally have avoided the need for any credit squeeze by instantly making all Hong Kong dollars - currency and deposits - fully convertible at a fixed price into US dollars by offering this convertibility to every member of the Hong Kong public. Logistically this plan was demanding, requiring large quantities of foreign currency banknotes to be flown into Hong Kong and prepared for distribution at bank branches throughout the territory, but it would have solved the crisis in the classical style by putting the reserves of the system behind the promise of convertibility at the fixed price. (See Appendix pp. 35-37 for the actual plan, as submitted.) The presumption underlying this plan was similar to the classical presumption applied in rescuing an individual bank from a bank run - namely, that the right way to deal with a run was to pay out cash currency until confidence returned and the run stopped.

In the case of Hong Kong in September 1983 it was not simply a run on one bank, but a run on the system as a whole. The implication was that the reserves of the system (i.e. the official foreign currency reserves) needed to be mobilised. Just as in a classical bank run it eventually becomes clear to those who have withdrawn cash that they are foregoing interest on their deposits and that their large holdings of cash are in themselves a considerable risk, causing money to flow back into the banking system, so it is for the case of a run on the system. Provided sufficient reserves can be paid out to anxious depositors, there eventually comes a point when the perceived need to convert deposits into reserves evaporates. In the case of Hong Kong the reserves were foreign currency so AMM's short term stabilisation plan proposed that the authorities prepare to meet any conceivable demand by flying in large quantities of foreign banknotes. In the past such a firm demonstration by the authorities was enough to end the panic, and in one case (in 1964) the packages of foreign banknotes were returned to London unopened.

Aside from offering an effective method of stopping the run on the currency, there was another argument in favour of adopting the emergency short-term stabilisation programme. This was that the provision of lender of last resort facilities by the Exchange Fund would have avoided the need for any sharp rise in interest rates, and hence avoided any damaging credit squeeze or any multiple contraction effects from the conversion of HK\$ deposits into foreign currency. On the other hand this kind of plan would have required extensive administrative preparations both for the distribution of foreign currency at bank branches in Hong Kong, and for the temporary pledging of suitable commercial bank assets with the Exchange Fund against advances of foreign currency.

The second course of action ran the risk that it might precipitate a tight credit squeeze on an already weakened economy with a battered property sector and an illiquid banking sector, but it entailed no major logistical operation involving planeloads of banknotes. There can be no doubt that everyone concerned was acutely aware of the risks in this latter option. From an analytical standpoint the extent of the resultant credit squeeze depended partly on the degree of public confidence in the likely success of the new measures (as this would have determined the size of the capital outflows), and partly on the level at which the new exchange rate was set (since a greater depreciation of the Hong Kong dollar would have enhanced the economy's competitiveness and hence any subsequent trade or current account surplus - and conversely).

The final outcome was that classical orthodoxy was set aside and the less dramatic but economically more risky solution was adopted; alternatively, full convertibility was rejected in favour of partial convertibility.

(c) The Choice of Currency

Assuming that for the long term a plan along the lines of AMM's Scheme 2B was to be adopted, from a purely technical point of view it would not have mattered which currency had been chosen as the unit in which to define Hong Kong's monetary standard. Without prejudice to the operation of the scheme it would have been possible to define the Hong Kong dollar in terms of Sterling, the US Dollar, the Yen, or DM, or any other convertible foreign currency. The important technical consideration ought to have been that the monetary reserves of the Exchange Fund could be held in that currency, and that the licensed banks should be able to obtain that currency without difficulty whenever they required new banknotes to meet the public needs. In practice this would have restricted the choice to one of the major trading currencies of the world.

Another set of possibilities was that the Hong Kong dollar could have been defined in terms of an artificial currency such as the SDR which consists of fixed amounts of individual currencies (i.e. the fiat money equivalent of a symmetallic standard), or a basket of currencies such as a trade-weighted index of other currencies. The advantage of choosing a composite monetary standard of this type was that instead of the Hong Kong economy being closely tied to the fluctuations of one particular economy it would be linked more broadly to the average trend in the major economies whose currencies comprised the basket, and hence to the global business cycle. The disadvantage of choosing this type of monetary standard was the problem of credibility with the ordinary man-in-the-street. A composite currency would have been much more difficult to understand, and in the early days of the new scheme public confidence was essential for success in avoiding an intense credit squeeze.

However, more important than these technical considerations was the political dimension to the choice of currency. If sterling were chosen it might have seemed to Peking that Britain was continuing to demonstrate a colonialist attitude towards Hong

Kong and this could have affected the British government's negotiating position at the Peking talks. The yen would have been a good choice on economic grounds since Japan's inflation rate is low, Japan is the dominant economy of the East Asian Pacific rim, and Japan is Hong Kong's third largest trading partner, but the memory of the Japanese occupation of Hong Kong and the long rivalry between the Chinese and the Japanese would have made the yen an unpopular choice on political grounds. The US dollar, on the other hand, was attractive on both technical and political grounds. Economically the U.S.A. is Hong Kong's largest trading partner, the US dollar is the dominant international trading currency, US inflation was currently low and the US economy is the primary force in the global business cycle. By tying Hong Kong's currency to the US dollar the authorities were simply recognising these realities. Politically the US dollar was a neutral currency so far as London and Peking were concerned, and by linking the Hong Kong currency to the US dollar the British negotiators in Peking could expect the Chinese to react favourably to the proposition that the Hong Kong dollar was now effectively a US dollar with a different denomination.

(d) The Choice of Exchange Rate

In the last few days before the Hong Kong government announced the currency stabilisation measures the exchange rate for the Hong Kong dollar was trading around HK\$8.30-8.40 against its American counterpart. In selecting an appropriate exchange rate there were three possible courses of action:

- a) to devalue the exchange rate by a further margin
- or b) to leave the rate at current market levels
- or c) to revalue upwards in an attempt to put the clock back to the pre-crisis period.

An outright devaluation by a further margin of, say, 20% from HK\$8.40 to HK\$10.50 (i.e. from US\$0.11905 to US\$0.09524) would have immediately raised the HK\$ price of imported goods, and as those prices percolated through the economy there would have been a once-for-all increase in the overall price level. Because the devaluation would have taken more time to filter through to such prices as labour or rents it might have seemed that such a devaluation would permanently raise the inflation rate (i.e. the on-going rate of change of prices), but these price changes should be considered as part of the once-for-all adjustment to the devaluation. With a lower US\$ price for HK\$, Hong Kong goods and services would have had a large competitive advantage, which would have generated a substantial improvement on the external accounts. Under a fixed exchange rate this would have led to a rapid increase in the domestic money supply, which would have allowed domestic prices such as wages and rents to rise. However, once equilibrium had been achieved (i.e. rough equality of prices in Hong Kong and the US at the fixed exchange rate), the overall rate of price change in Hong Kong would be determined by overall price changes in the US. The disadvantage of devaluation was therefore that it would immediately have produced this adverse once-for-all domestic price change, but against that it would have had the advantage of producing a balance of payments surplus and hence a monetary expansion which, in the short term, would have helped to reliquify the economy.

Setting the official level for the new exchange rate at the prevailing market rate would have had two possible advantages. First it would have meant minimising the extent of price adjustments throughout the economy, and second it could be argued that the existing market rate was the rate most likely to inspire public confidence. However it could equally well be argued that since the depreciation in the preceding weeks had not yet percolated through to all prices in the economy, accepting the current market level as a permanent level was defeatist. Why not take the opportunity to roll back inflation by setting the rate at a higher, stronger level against the US\$?

The argument for revaluation is the exact converse of the argument for devaluation above. In brief, the argument in favour of upward revaluation was that it would bring about a once-for-all decline in the domestic price level, but the cost of this would have been a balance of payments position which would have produced a smaller increase in money supply, and hence a temporarily tighter domestic liquidity situation.

The precise level chosen for the exchange rate was not important for the long run adjustment of the economy. Given the mechanism in Scheme 2B whereby the money supply would adjust automatically to the balance of payments, no matter what level of exchange rate was actually chosen the economy and the domestic price level would eventually have adjusted to the new rate. However the level chosen for the exchange rate would clearly have affected the economy and the price level in the short run as implied by the analysis in the preceding paragraphs. In the end the choice of exchange rate was not a matter of precise economic calculation; as the Financial Secretary said in answer to a question after setting the new rate, it was a matter of "acute personal judgement".

SECTION 4

INSTITUTIONAL ARRANGEMENTS OF THE NEW SCHEME

Under the new monetary arrangements announced on October 15th the Exchange Fund issues and redeems Certificates of Indebtedness to the two note-issuing banks at the fixed rate of HK\$7.80 per US\$. The two note-issuing banks have agreed to sell and re-purchase HK\$ banknotes at this same rate with all other licensed banks in Hong Kong, in effect acting as agents for the Exchange Fund. The government has not made the fixed 7.80 conversion facility available to the non-bank public, and has made no guarantees in respect of the foreign currency price of deposits or cash held by the public which are free to trade at market rates.

These arrangements meet the two requirements of an automatic, non-discretionary fixed exchange rate system specified in "How to Rescue the Hong Kong Dollar: Three Practical Proposals" (see AMM Vol. 7 No. 5, p.26), namely

- (1) that whatever serves as base money should be available in unlimited amounts at a stated price in foreign currency terms, and that it should be redeemable on similar terms in indefinite quantities, and
- (2) convertibility or interchangeability between base money and the deposit money issued by the banks.

The mechanism thus established is basically the same as an old-fashioned gold or silver standard, except that Hong Kong uses the US dollar as its monetary standard in place of a precious metal, and the non-bank public does not have direct access to convertibility at the official parity as under the classical gold standard. Under this system there are two main forces tending to produce market rates of exchange for the Hong Kong dollar close to the official 7.80 rate for Certificates of Indebtedness. (There is a third mechanism, known as the goods arbitrage approach or the law of one price level, but here we shall only deal with the narrower monetary aspects of the adjustment mechanism.)

First, licensed banks are able to arbitrage between the free market rate for Hong Kong dollars or US dollars and the Exchange Fund's rate for Certificates of Indebtedness, buying in the cheaper market and selling in the dearer market. This kind of arbitrage will continue until the difference between the returns from holding deposits (making loans) and the returns from holding cash in either market is equal to the transaction costs

of these operations. Deviations between the official rate and the free market rate are thus comparable to deviations between the official parity for gold and its free market price under the gold standard, with the upper and lower bounds of the free market given by the so-called gold points.

The incentive for banks to sell Hong Kong dollar banknotes (or CIs) to the Exchange Fund through this kind of arbitrage only exists when the free market rate for HK\$ is at a discount to the official rate (e.g. at 7.82, 7.83 etc.). Sales or redemptions of HK\$ banknotes to the Exchange Fund by the banks in these circumstances will tend to reduce the banks' cash-to-deposit ratio, causing them to restrict their lending in HK\$ funds, tightening liquidity in the system and raising interest rates. If such a squeeze were to continue it would in time lead to reduced lending and slower money supply growth.

Since the HK\$ rate in the free market will only be at a discount when there is an overall balance of payments deficit (e.g. due to an increased capital outflow, or due to a deterioration in the current account), this type of arbitrage will tend to restrict the money supply and raise interest rates. Both of these effects will bring the free market rate for Hong Kong dollars back towards the official parity.

A converse set of statements applies to the case of the incentive for banks to purchase Hong Kong dollar banknotes (or CIs) from the Exchange Fund. However, since banknotes are a non-earning asset for the banks, banks will tend to expand their lending when the Hong Kong dollar is at a premium to the US dollar rather than maintain non-earning cash balances. Consequently when the HK\$ is at a premium to the US\$ this will be consistent with monetary expansion, which in due course will tend to produce balance of payments effects which will eliminate the premium on the Hong Kong dollar.

The second element of the mechanism tending to keep the free market rate close to the official parity results from competition among the banks. Since bank customers are free to convert Hong Kong dollar deposits into cash at any time, they can, by exercising that right, shop around amongst the banks for the most favourable HK\$/US\$ rate for their HK\$ banknotes. Theoretically it should be possible for a customer with a large quantity of banknotes to negotiate a price for his banknotes very close to the official parity of 7.80. It is unlikely that this type of transaction will need to occur, but the mere expectation that it could occur will be sufficient to keep the free market rate for banknotes close to the official parity for Certificates of Indebtedness. Banks which offer unfavourable rates can expect to lose customer deposits and lose market share. Hence the importance of the convertibility provision in (2) above, and the importance of free competition among the licensed banks.

There are two features of the new scheme as implemented from October 17th which differ from the proposals set out in AMM's Scheme 2B. First, in our proposals it was suggested (p. 31) that all banks should have direct access to the official rate for CIs, and should be able to sell banknotes direct to the Exchange Fund instead of to the two note-issuing banks. In the scheme as implemented the two note-issuing banks are in effect appointed agents of the Exchange Fund, and all other banks must deal with them, not with the authorities. Given the decision of the authorities not to deal with all banks and the requirement that the note-issuing banks pass on the 7.80 parity to all other licensed banks, the two note-issuing banks were left in the position that other banks would be able to buy or sell US\$ at 7.80 or withdraw HK\$ cash against HK\$ demand deposits with the Hongkong and Shanghai Bank or Chartered Bank. In the event of a sudden large movement of the free market rate, other banks could rapidly adjust their positions at the two note-issuing banks, and all of the strain of adjustment in the system would fall on the two note-issuers. Presumably to avoid this problem the system has been set up so that other banks are obliged to pay US\$ for all purchases of HK\$ banknotes (i.e. they may not draw on their Hong Kong dollar demand deposit accounts at

the note-issuing banks for purchases of banknotes), and conversely for all redemptions of HK\$ banknotes the note-issuing banks will pay US\$. Thus in effect all banks are now note-issuing banks in the sense that every new banknote they obtain has been paid for by them at the Exchange Fund with US\$.

A second important difference between the scheme as implemented and the proposals put forward by AMM is the Hong Kong authorities' decision not to abolish the Interest Rate Agreement of the Hong Kong Association of Banks (HKAB). The failure to abolish the interest rate cartel means that the overall structure of interest rates in Hong Kong adjusts imperfectly to changes in interest rates abroad, or to changes in the supply and demand for credit in Hong Kong, or to changes in perceived rates of return in Hong Kong. Insofar as there are some interest rates which are free (e.g. the interbank and wholesale rates applicable on deposits in excess of HK\$500,000) and some which are administered by the cartel, the whole burden of adjustment will temporarily be forced on to the free market interest rates, making those rates act as a kind of safety valve (at least until cartel rates are altered), and almost certainly causing free market rates to be more volatile than they would normally be if there was no interest rate cartel. In the absence of the Interest Rate Agreement the whole structure of rates would adjust more slowly and more gradually than is likely as long as the Agreement remains in effect.

The following pages present the key documents of the Hong Kong dollar stabilisation scheme, together with a newspaper report on the press conference given by the Financial Secretary immediately following his announcement of the scheme. As an Appendix we include the short term stabilisation plan proposed by the editor which would have provided for full convertibility of the Hong Kong dollar. The next issue of AMM will report on how the stabilisation scheme has operated in practice, and on the consequences of some of the Financial Secretary's remarks concerning possible changes in the fixed parity for Certificates of Indebtedness.

OFFICIAL TEXT OF THE HONG KONG MONETARY STABILISATION SCHEME AS ANNOUNCED BY SIR JOHN BREMRIDGE

Noon, 15 October 1983

Statement by Financial Secretary

I want to tell you about two steps which the Government is taking now to stabilise the exchange rate of the Hong Kong dollar.

2. First let me give you some background. For 37 years from 1935 to July 1972 the Hong Kong dollar was pegged to sterling. In those days the sterling area existed and for most of that period the international monetary system was characterised by fixed exchange rates. From 1972 to November 1974 the Hong Kong dollar was pegged to the US dollar. Since 1974 Hong Kong in common with other major market economies has had a freely floating exchange rate. This floating system has served us well. It has given us a measure of insulation from the ups and downs of other economies, and under it Hong Kong has recorded very high rates of economic growth. Living standards have risen accordingly.

3. Towards the end of last year the exchange rate started markedly to weaken, reflecting amongst other factors uncertainties about Hong Kong's future.

4. Before the government announced three weeks ago that it was considering proposals to stabilise the exchange rate, currency depreciation was tending increasingly to feed on itself in an unstable and irrational manner. This depreciation was not justified by either current economic developments or future prospects. The economy has rebounded and is doing very well. There is little unemployment and exports are booming. Hong Kong has substantial foreign currency reserves, a generally liquid banking system and virtually no Government debt.

5. The Government has been concerned by the falling exchange rate and has done everything in reason, within the established framework, to attempt to stabilise it. These efforts have achieved only limited success.

6. The circumstances of Hong Kong preclude exchange control. After a thorough examination of realistic options, we have now decided to alter the framework within which the exchange rate is determined. With effect from Monday 17th October, the two note-issuing banks will pay the Government's Exchange Fund for additional Certificates of Indebtedness, which they are required to hold as backing for any increase in their note issues, in foreign exchange at a fixed rate of HK\$7.80 equals US\$1.

7. From the same date, when notes are withdrawn from circulation and the note-issuing banks surrender Certificates of Indebtedness the Exchange Fund will pay them the equivalent foreign exchange at the same fixed rate. It is our intention to hold this rate unchanged.

8. The rates of exchange which a bank customer will obtain, whether exchanging bank notes or making any other foreign currency transactions, will continue to be determined by market forces, but will in practice be close to the fixed rate of HK\$7.80 equals US\$1. This will be the case because from next Monday market forces will operate against the background of the fixed rate for Certificates of Indebtedness. I must emphasise that these new arrangements will mean business as usual between banks and their customers at stabilised rates.

9. You will ask about the implications for the economy of stabilising the exchange rate in this way. In the short term there may be some upward pressures on Hong Kong dollar interest rates. Once the stability of the exchange rate becomes evident and accepted, interest rates should fall below present levels. Looking further ahead changes in the exchange rate will no longer be an element in our economy's adjustment process. Factors such as interest rates and money supply will adjust to balance of payments pressures automatically without Government intervention.

10. The Government believes that this new arrangement must now be preferred to the freely floating exchange rate system. We cannot run the risk of further spiralling depreciation, with the rampant inflation and distress which that would bring to all our community. A return of confidence in our currency is essential.

11. I said that I had two measures to announce. The second is this. As from Monday 17th October interest on Hong Kong dollar deposits with financial institutions will no longer be taxed. This means that there will no longer be a tax advantage in holding foreign currency deposits or in holding Hong Kong dollar deposits offshore.

12. As I said last month, the Government must take account of the possible erosion of profits tax revenue arising from the removal of interest tax. We are still studying this complex issue. In removing interest tax on Hong Kong dollar deposits with financial institutions, we are doing the most that is possible, pending the outcome of our study. I hope to be in a position to propose more lasting reforms in these fields of taxation in the budget next February.

13. These measures are designed to stabilise the exchange value of the Hong Kong dollar, and thus to provide a climate for growing prosperity with restrained inflation. The Government has confidence in the stabilised exchange rate. So can the people of Hong Kong. Let us now get on with our business.

Government Information Services

15 October 1983

MULTI ADDRESS CALL

15 OCTOBER 1983

URGENT MESSAGE FOR YOUR CHIEF EXECUTIVE

FROM : SECRETARY FOR MONETARY AFFAIRS, HONG KONG GOVERNMENT

SUBJECT : GOVERNMENT MEASURES TO STABILISE THE EXCHANGE RATE :
EXPLANATORY NOTE

THE FINANCIAL SECRETARY HAS TODAY ANNOUNCED TWO STEPS DESIGNED TO STABILISE THE EXCHANGE RATE OF THE HONG KONG DOLLAR. ONE STEP IS THE REMOVAL OF INTEREST TAX ON HONG KONG DOLLAR DEPOSITS WITH FINANCIAL INSTITUTIONS, THE OTHER INVOLVES REVISED ARRANGEMENTS FOR THE ISSUE AND REDEMPTION OF BANKNOTES. THIS MESSAGE CONCERNS THE LATTER.

2. THE CENTRAL ELEMENT IN THE NEW ARRANGEMENTS IS THAT, FOLLOWING AGREEMENT BETWEEN THE GOVERNMENT AND THE TWO NOTE-ISSUING BANKS, CERTIFICATES OF INDEBTEDNESS, WHICH ARE ISSUED BY THE HONG KONG GOVERNMENT EXCHANGE FUND TO THE NOTE-ISSUING BANKS TO BE HELD AS COVER FOR THEIR NOTE ISSUES, WILL HENCEFORTH BE ISSUED AND REDEEMED ONLY AGAINST PAYMENT IN US DOLLARS, AT THE FIXED EXCHANGE RATE OF USD1 = HKD7.80. THE FORCES OF COMPETITION AND ARBITRAGE SHOULD THEN ENSURE, AS THEY DO AT PRESENT, THAT APPROXIMATELY THE SAME RATE OF EXCHANGE IS AVAILABLE ON TRANSACTIONS IN ALL TYPES OF INSTRUMENT. IN OTHER WORDS, EXCHANGE RATES QUOTED IN THE MARKET FOR THE US DOLLAR WILL BE CLOSE TO THE RATE OF HKD7.80 FIXED FOR CERTIFICATES OF INDEBTEDNESS.

3. TO ASSIST THE SMOOTH AND EQUITABLE FUNCTIONING OF THIS ARRANGEMENT, THE NOTE-ISSUING BANKS HAVE AGREED WITH THE GOVERNMENT THAT THEY SHOULD PROVIDE NOTES TO, AND ACCEPT THEM FROM, OTHER BANKS ON THE SAME BASIS AS THEY THEMSELVES DEAL WITH THE EXCHANGE FUND - I.E. AGAINST PAYMENTS IN US DOLLARS AT THE RATE OF USD1 = HKD7.80. THE NOTE-ISSUING BANKS WILL BE NOTIFYING OTHER BANKS INDIVIDUALLY OF THE CONSEQUENT REVISIONS TO THEIR PROCEDURES FOR PROVIDING NOTES AND FOR TAKING THEM BACK.

4. IT SHOULD BE STRESSED THAT THE MARKET RATE WILL HOLD CLOSE TO THE ANNOUNCED RATE WITHOUT ANY NEED FOR INCREASED TRANSACTIONS IN BANK NOTES. THE MERE FACT THAT DEPOSITS ARE CONVERTIBLE (AT MATURITY, WHERE RELEVANT) INTO NOTES AND THAT HKD NOTES ARE ULTIMATELY CONVERTIBLE (VIA CERTIFICATES OF INDEBTEDNESS) INTO FOREIGN CURRENCY WILL, ASSISTED BY THE FORCES OF COMPETITION AND ARBITRAGE, ENSURE CONVERTIBILITY BETWEEN HKD DEPOSITS AND FOREIGN CURRENCY DEPOSITS AT A RATE DETERMINED PRINCIPALLY BY THE FIXED RATE FOR CERTIFICATES OF INDEBTEDNESS, WITHOUT ANY INTERMEDIATE TRANSACTIONS IN NOTES HAVING TO TAKE PLACE.

5. NEITHER DTCS NOR ANY OTHER BANK CUSTOMERS SHOULD EXPECT THERE TO BE ANY CHANGE IN THE MANNER IN WHICH THEY DRAW NOTES FROM OR DEPOSIT NOTES WITH, BANKS. THE NEW ARRANGEMENTS DO NOT AFFECT BANK CUSTOMERS DIRECTLY. CUSTOMERS WILL MERELY FIND THAT THE QUOTED EXCHANGE RATE IS CLOSE TO HKD7.80, WHETHER FOR EXCHANGING NOTES OR FOR OTHER FOREIGN EXCHANGE TRANSACTIONS. AS A RESULT OF THE GOVERNMENT FIXING THE RATE FOR CERTIFICATES OF INDEBTEDNESS, THE EXCHANGE RATE AVAILABLE TO BANK CUSTOMERS WILL ALSO REMAIN STABLE.

6. AS REGARDS BROADER IMPLICATIONS, ESSENTIALLY THE NEW SCHEME TRANSFERS THE IMPACT OF ANY ADJUSTMENT TO BALANCE OF PAYMENTS PRESSURES AWAY FROM THE EXCHANGE RATE AND ONTO THE BANKING SYSTEM, AND MORE SPECIFICALLY ONTO THE LIQUID RESERVE BASE OF THE BANKS AND ONTO THE LEVEL OF INTEREST RATES PAID AND CHARGED ON HKD DEPOSITS AND LOANS. THUS, FOR EXAMPLE, A CAPITAL INFLOW MAY LEAD TO INCREASES IN LIQUIDITY AND LOWER INTEREST RATES, WHILE A CAPITAL OUTFLOW MAY GIVE RISE TO A SQUEEZE ON LIQUIDITY AND HIGHER HKD INTEREST RATES, INSTEAD OF LEADING, AS AT PRESENT, TO DEPRECIATION OF THE CURRENCY. IN THE EVENT OF AN OUTFLOW THE IMPACT MIGHT BE MORE SEVERE ON SOME BANKS THAN ON OTHERS, AND THE CONSEQUENCES FOR OTHER SECTORS, SUCH AS DTCS AND CORPORATE OR INDIVIDUAL BORROWERS, MIGHT BE PAINFUL. THE GOVERNMENT WILL BE MONITORING THE SITUATION CAREFULLY, PARTICULARLY IN ITS INITIAL STAGES. THE COMMISSIONER OF BANKING AND OF DEPOSIT-TAKING COMPANIES WILL KEEP A CLOSE WATCH ON THE EFFECTS OF THE SCHEME ON INDIVIDUAL BANKS AND DTCS, THE GOVERNMENT WOULD BE PREPARED TO CONSIDER ACTION TO MITIGATE ANY DIFFICULTIES THAT MIGHT ARISE IN PARTICULAR CASES.

MONETARY AFFAIRS BRANCH

TOD 151226

MULTI ADDRESS CALL

DEPOSIT INTEREST RATES

THE HONG KONG ASSOCIATION OF BANKS MET THIS MORNING AND DECIDED TO LEAVE THE DEPOSIT INTEREST RATES UNCHANGED. THIS DECISION WAS TAKEN AFTER GIVING CONSIDERATION TO THE ANNOUNCEMENT BY GOVERNMENT OF MEASURES TO STABILISE THE EXCHANGE RATE OF THE HONG KONG DOLLAR.

COMMENTING ON THESE MEASURES THE COMMITTEE WELCOMED THE DECISION TO ABOLISH THE WITHHOLDING TAX ON HONG KONG DOLLAR DEPOSITS - A MEASURE IT HAS CONSISTENTLY ADVOCATED AS BEING NECESSARY TO REMOVE THE TAX ADVANTAGE IN HOLDING FOREIGN CURRENCY DEPOSITS OR IN HOLDING HONG KONG DOLLAR DEPOSITS OFFSHORE.

THE COMMITTEE FULLY ENDORSED THE VIEW OF GOVERNMENT THAT THE NEW ARRANGEMENT TO REQUIRE THE NOTE-ISSUING BANKS TO CONDUCT TRANSACTIONS WITH THE GOVERNMENT'S EXCHANGE FUND IN REGARD TO CERTIFICATES OF INDEBTEDNESS, AT A RATE OF EXCHANGE FIXED AGAINST THE US DOLLAR, IS A SENSIBLE MEASURE WHICH SHOULD RESTORE STABILITY TO THE EXCHANGE MARKET WITH THE MINIMUM OF OFFICIAL INTERFERENCE WITH MARKET FORCES.

IN RECOGNISING THAT THE NEW ARRANGEMENTS MAY NECESSITATE MORE FREQUENT ADJUSTMENTS TO INTEREST RATES, THE COMMITTEE DECIDED TO MEET IN FUTURE IN THE MORNINGS AS AND WHEN NECESSARY. THE PRACTICE OF MEETING ON SATURDAYS TO REVIEW INTEREST RATES AND THE MARKET SITUATION GENERALLY WILL CONTINUE.

IN A SEPARATE JOINT ANNOUNCEMENT THE CHARTERED BANK AND THE HONGKONG AND SHANGHAI BANKING CORPORATION ANNOUNCED THAT THEY WOULD BE ISSUING TODAY AN INFORMATION NOTICE TO BANKS EXPLAINING THE METHOD BY WHICH THE NEW ARRANGEMENTS FOR THE ISSUANCE AND REDEMPTION OF THEIR NOTES WILL BE CONDUCTED BETWEEN THEMSELVES AND OTHER BANKS. THE NEW PROCEDURES WILL BE IN PLACE BY MONDAY MORNING TO ENABLE THE EXCHANGE MARKET TO REOPEN AT THE NORMAL TIME WITHOUT DISRUPTION TO BUSINESS.

CHAIRMAN

DATED 15 OCTOBER 1983

TOD 151345

**LETTER FROM HONGKONG AND SHANGHAI BANKING CORP.
TO ALL LICENSED BANKS IN HONG KONG.**

15 October 1983

Dear Sir

HONG KONG DOLLAR NOTE ISSUE

You will be aware that the Government has announced that the Exchange Fund will in future issue and redeem Certificates of Indebtedness to the note-issuing banks against US Dollars at a fixed parity which will be set by Government.

The note-issuing banks have agreed that they in their turn will require payment in US Dollars when HK Dollar notes are drawn from their Treasuries and will make payment in US Dollars when HK Dollar notes are deposited. For all such transactions the prevailing parity rate will be used.

It is anticipated that your daily operations may require more than one withdrawal and/or deposit of HK Dollar notes at our Treasuries and we will accordingly aggregate or set off such receipts and deliveries during the day so that only one payment to or from your bank in US Dollars is required. This arrangement will reduce the volume of payments needed in New York, but we reserve the right to suspend the arrangement if it should prove operationally necessary to do so.

To facilitate the day-to-day accounting and to avoid any unnecessary transfer of US Dollar funds where there might be more than one cash transaction in any one day, we have arranged to open a US Dollar Settlement account (to which the number has been allocated) in your name in our books. All transactions will, in the first instance, be routed over the account with settlement of the net daily position being effected by you, or us as the case may be, at the end of the day. Settlement of funds due to us can be made in one of the following ways:-

- (a) by remittance, for same day value, to the Hongkong and Shanghai Banking Corporation, New York for account The Hong Kong and Shanghai Banking Corporation, Hong Kong.
- (b) by arranging for the purchase of US dollars for same day delivery from our dealers who can be contacted on telephone no. 5-263171 for a rate quotation. The cost of the purchase will be debited to your Hong Kong dollar current account or you may provide us with your Cashier Order.

or

- (c) by arranging an overnight US dollar overdraft facility on which interest will be charged at the prevailing rate.

Settlement for any balance due to you will be effected by us to your nominated bank in the United States of America, or should you wish, you may contact our dealers on telephone no. 5-263171 who will quote a rate for the purchase from you of the US Dollars, the proceeds then being applied to the credit of your HK Dollar account in our books.

To ensure that settlements are effected smoothly in New York, we should be grateful if you would advise us as a matter of urgency details of your settlement account in New York, the name and ABA number of your bankers and the relative CHIPS UID number. In the interests of simplicity, only one account should be used for both payments and receipts of US dollars. Details of our account in New York are as follows:-

Correspondent - The Hongkong and Shanghai Banking Corporation

CHIPS UID NO. -

Account - The Hongkong and Shanghai Banking Corporation,
Hong Kong
A/C No.

We attach specimens of letters which we would request your staff to use with effect from 17 October 1983 for the withdrawal and deposit of HK dollar notes. The letters must be signed by duly authorised signatories and delivered to the Bank in duplicate at the time of effecting HK dollar cash transactions.

We shall be grateful if you will confirm your agreement to the opening of the US Dollar Settlement Account in your name in our books by providing us with a resolution to that effect, at the same time providing us with the names and specimen signatures of your authorised signatories for the account.

We trust that this explains the procedures to be followed and should be grateful if you would request your staff to contact our Miss Doris Leung on 5-2672260 if you have any queries.

Yours faithfully,

H.W. Paterson
Assistant Manager
Foreign Exchange and Treasury

**STANDARD LETTERS ISSUED BY H.S.B.C. FOR USE BY OTHER
LICENSED BANKS WITHDRAWING OR DEPOSITING BANKNOTES**

The Manager
The Hongkong and Shanghai
Banking Corporation
Main Treasury
Hong Kong

Dear Sir

Withdrawal of Cash

Please deliver to our authorised representative the sum of HKD (Hong Kong Dollars) in reimbursement for which we hereby authorise you to debit our US Dollar Settlement Account No. in your books with USD being the equivalent at the rate of HKD as laid down by Government.

In cover of the debit to our account

(a) we will arrange to remit USD to The Hongkong and Shanghai Banking Corporation, New York, for your account value today through our designated correspondent bank.

or

(b) we have arranged a US Dollar purchase contract with your dealers for credit to our account value today.

Yours faithfully

The Manager
The Hongkong and Shanghai
Banking Corporation
Main Treasury
Hong Kong

Dear Sir

Deposit of Cash

We deliver to you herewith HKD (Hong Kong Dollars) and would request you to credit our US Dollar Settlement Account No. with you with USD being the equivalent at HKD to USD1.00 as laid down by Government.

In settlement of the credit to our account

(a) remit the proceeds to our account in New York in accordance with our standing instructions.

or

(b) we have arranged a US Dollar sale contract with your dealers for debit to our US Dollar Settlement Account No. value today. The proceeds should be credited to our Current Account No. in your books.

Yours faithfully

South China Morning

XXXIX No. 286

HONGKONG, SUNDAY, OCTOBER 16, 1983

Post



US peg to hold up our dollar

By MICHAEL BLENDALL
Financial Editor

The Government yesterday "linked" the Hongkong dollar to the US dollar and abolished the withholding tax on Hongkong dollar-denominated deposits.

As from tomorrow, the Hongkong dollar is effectively pegged to an exchange rate of \$7.80 with the greenback and, according to the Financial Secretary, Sir John Brembridge: "It is our intention to hold this rate unchanged."

"I must emphasise that these new arrangements will mean business as usual between banks and their customers at stabilised rates," he said.

Given that the Hongkong dollar was trading against the greenback at \$8.24/25 just before Typhoon Joe closed the forex markets on Thursday, and before the ensuing Chung Yung Festival holiday on Friday, this is tantamount to a five per cent revaluation.

The implications for interest rates, however, are not so good with the Government anticipating some "short-term pressure."

The Hongkong Association of Banks did not hike the prime rate yesterday after its usual Saturday meeting, but the rationale is that rates may have to rise to encourage people not to take advantage of what looks like a bargain-basement price for US dollars — after their recent peak of \$9.50.

But they should fall below present levels once the "stability of the exchange rate becomes evident and accepted," and capital inflow hopefully pours into the territory to take advantage of rates that are already high by world standards.

With the next round of Sino-British talks on Hongkong's future due to start on Wednesday, the Government's much-vaulted monetary package did not come a minute too soon.

After all, the recent depreciation of the currency "was tending to feed on itself in an unstable and irrational manner," as Sir John put it.

And the depreciation "was not justified by either current economic developments or future prospects; the economy has rebounded and is doing very well; there is little unemployment and exports are booming; Hongkong has substantial foreign currency reserves, a generally liquid banking system and virtually no Government debt."

The new scheme is similar to the system that existed between 1972 and 1974 (the Hongkong dollar was pegged to sterling for 37 years before that) when the currency was actually tied to the US dollar.

This time around, however, the framework within which the exchange rate is determined has effectively been altered.

The two note-issuing banks — Hongkong and Shanghai Banking Corp and the Chartered Bank — will now pay the Government's Exchange Fund for additional certificates of indebtedness (which they are required to hold as backing for any increase in their note issues) in foreign exchange at a fixed rate of \$7.80.

When notes are withdrawn from circulation and the note-issuers duly surrender their certificates (CIs), the Exchange Fund guarantees convertibility at the same rate.

"The rates of exchange which a bank customer will obtain, whether exchanging bank notes or making any other foreign currency transactions," Sir John told a press conference, "will continue to be determined by market forces but will, in practice, be close to the fixed rate for CIs."

This tended to be borne out in the forex markets yesterday where, after a dull morning characterised by little dealing beyond a trickle of genuine commercial demand, the exchange rate promptly came back from around the \$8.10 mark to \$7.90 after the noon announcement, with Hongkong and Shanghai quoting \$7.79½/80½.

And it looks inevitable that China will devalue the renminbi tomorrow — a bull point for Hongkong's inflation rate — to bring it into line with the Hongkong dollar's new exchange rate.

If the US dollar turns volatile, Sir John said he will consider linking the Hongkong dollar to a basket of currencies.

The Government believes that the new arrangement must now be preferred to the freely-floating exchange rate system.

"We cannot run the risk of further spiralling depreciation with the rampant inflation and distress which that would bring to all our community," Sir John said.

"A return of confidence in our currency is essential."

And as he pointed out: "The circumstances of Hongkong preclude exchange control."

Commenting on the new measures, the Governor, Sir Edward Youde, said they were the result of "the most careful consideration" which echoed what he had said in his Legislative Council address during the week.

"They represented a firm expression of confidence in the currency and the strength of the economy which underlies it; and were a further example of the Government's determination to do everything in their power to assure the stability and prosperity of the territory and the well-being of its people."

Sir John admitted that the Hongkong Government had had discussions with both the British Government and the Bank of England concerning the package, which was foreshadowed three weeks ago.

He also gave assurances that the Government would only change the "linked" rate against the greenback in Hongkong's favour: "We won't change it the other way."

And the Secretary for Monetary Affairs, Mr Douglas Blye, asserted that arbitrage and competition would ensure that free market rates stayed more or less in line with the established \$7.80.

Questioned as to how the Government had arrived at that figure, Sir John said that it was a matter of "acute personal judgment."

It is a judgment, however, that implies a considerable premium for the political factor, given the Government's oft-expressed contention that \$6.50 was a "realistic" exchange rate against the US dollar on economic considerations.

Sir John also stated quite categorically that no further structural changes were in train — or envisaged — to shore up the currency.

"We have no other contingency plans, but we are cognisant of the fact that our foreign currency reserves very substantially exceed the note issue," he said.

Nevertheless, the lack of phased structural back-up is worrying in view of the fact that the guaranteed HK\$7.80 rate of convertibility for US\$1 applies only between the Exchange Fund and the note-issuing banks, and the effect that this could have if the political situation deteriorates significantly taking confidence with it.

As for the removal of the withholding tax — which, according to Sir John, will only cost about \$250 million in lost receipts this year and will be taken from the Exchange Fund this time around so that it doesn't have an impact on the projected deficit — it is unlikely to do much more than correct a glaring inequity as distinct from encouraging any rush out of US dollars.

APPENDIX



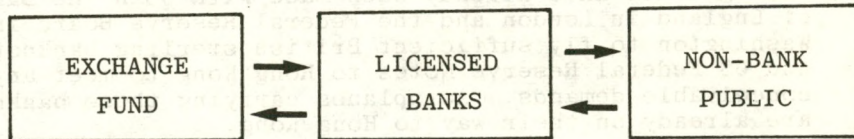
ASIAN MONETARY MONITOR LIMITED

Hong Kong
September 26th, 1983

ESSENTIAL ELEMENTS OF A MONETARY STABILISATION PROGRAMME FOR HONG KONG

SUMMARY

- (1) CONVERTIBILITY OF THE HK\$ AT A FIXED RATE IN STERLING*
COMBINED WITH A STRONG POLITICAL STATEMENT THAT BRITAIN**
IS BACKING THE PROSPERITY OF THE PEOPLE OF HONG KONG.
- (2) DEMONSTRATE THE CONVERTIBILITY OF THE CURRENCY BY
FLYING IN STERLING AND U.S. DOLLAR BANKNOTES.
- (3) EXPLAIN HOW THE MECHANICS OF CONVERTIBILITY WILL OPERATE.



- (4) DEAL WITH THE IMPLICATIONS FOR BANKS' BALANCE SHEETS:
THE EXCHANGE FUND AS LENDER OF LAST RESORT.
- (5) ENSURE THAT THE AUTOMATIC ADJUSTMENT MECHANISM WILL
WORK SMOOTHLY IN THE FUTURE.

* or US\$, or SDRs, or any other basket of currencies.

** or the Government of Hong Kong, or both Governments together.

(Similar alternative options apply to statements on the following pages.)

P.O. Box 30724, Causeway Bay, Hong Kong.



ASIAN MONETARY MONITOR LIMITED

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ESSENTIAL ELEMENTS OF A MONETARY STABILISATION PROGRAMME FOR HONG KONG

A simultaneous announcement is required from (1) H.M. Government in Britain on behalf of the Cabinet and the Bank of England and (2) the Governor of Hong Kong on behalf of the Governor-in-Council and the Monetary Affairs Branch to the effect that:

- (1) The Government of Hong Kong and the Exchange Fund, together with the British Government and the Bank of England stand behind the Hong Kong dollar and the people of Hong Kong. As from (date, time) they will guarantee the convertibility of Hong Kong dollar banknotes into sterling at a fixed rate of ____ (or approximately US\$ ____). The available resources of the Exchange Fund and the Hong Kong Government together exceed (3?) times the total Hong Kong dollar banknote issue, and in addition the Bank of England stands ready to make further resources available.*
- (2) Arrangements have already been made with both the Bank of England in London and the Federal Reserve Board in Washington to fly sufficient British sterling banknotes and US Federal Reserve Notes to Hong Kong to meet any conceivable demands. Aeroplanes carrying those banknotes are already on their way to Hong Kong.

(The arrival of the banknotes at Kai Tak Airport should be staged as a news-event. These measures will demonstrate the credibility of the public announcement and help to restore public confidence as early as possible.)

- (3) The convertibility of Hong Kong dollar banknotes into sterling means that any individual may go to his bank and obtain sterling (or US\$ foreign currency notes) against Hong Kong dollar banknotes at the fixed rate. These conversion facilities will be provided by all Licensed Banks, and in turn all licensed banks will be granted access to the Exchange Fund for the purpose of redeeming HK\$ banknotes under special orders to be incorporated in legislative form by amendment to the Exchange Fund Ordinance.
- (4) To ensure that Licensed Banks will have ample sterling or equivalent foreign exchange to meet the needs of their depositors, the Exchange Fund will stand ready to provide

* N.B. It is inconceivable that these facilities would actually be required.

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such foreign exchange to any Licensed Bank on the security of either Hong Kong dollar assets or foreign currency assets equal in value to 120% of the amount of foreign currency required by each bank.

(This enables banks to shift their portfolios as between Hong Kong dollar assets and liabilities and foreign currency assets and liabilities. From the standpoint of the Hong Kong Government, however, it will demonstrate publicly that sterling and Hong Kong dollars are each as good as the other.)

- (5) Henceforward all issues of Hong Kong dollar banknotes will be authorised only against payment by the 2 note-issuing banks of sterling or other equivalent convertible currencies at the accounts of the Exchange Fund in London and New York. The Hong Kong dollar always has been and will remain fully backed by foreign currencies. In the past decade the Hong Kong dollar has not been fixed to other currencies and this has recently given rise to undue anxiety both in the business community and among the ordinary people of Hong Kong. By fixing the price of the Hong Kong dollar in sterling we will remove that anxiety once and for all.

I believe that, taken together and announced with appropriate political statements about the commitment of the British Government to the prosperity of Hong Kong, these measures would be sufficient both to stop the temporary crisis, and to put Hong Kong's monetary system firmly back on the rails after a decade of drift.

Signed,

John G. Greenwood
Economist, G.T. Management (Asia) Ltd.

JGG/il

Revised from 25/9/83.

P.O. Box 30724, Causeway Bay, Hong Kong.

THE CHANGING COMPOSITION OF ECONOMIC GROWTH

There have been some signs recently of a pick-up in consumption in Japan but generally there is as yet only slight evidence of the widely anticipated recovery in the domestic sector of the economy. As Chart 1 depicts, the narrow indicators of consumption have been on a long downtrend since early 1980. The current recovery in the Japanese economy, which began in the second quarter of this year, has been led by the external sector, as exports have surged on the back of the strong recovery in the USA. Indeed, the GNP figures for the second quarter reveal that of the 0.9% growth for that quarter 0.5% could be attributed to net exports, with the private domestic sector (not including stock building) contributing a negative figure, of -0.4%.

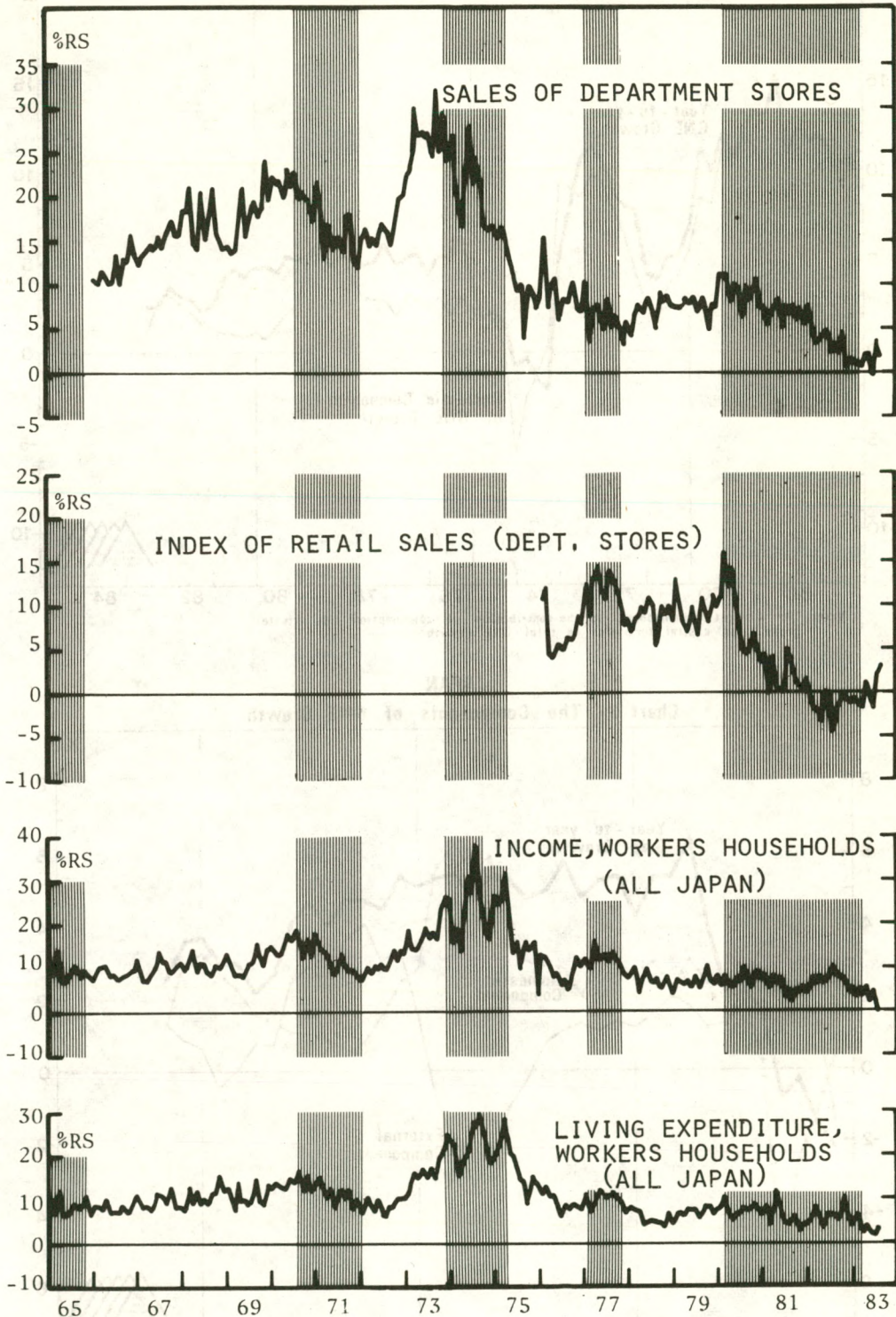
The study of the components of Japanese GNE is particularly important as, since the Bank of Japan's switch to a strict monetarist policy of maintaining a stable growth of the money supply in 1974, overall economic growth has ceased to be particularly cyclical. Instead it has been the components of GNE rather than the total which have borne the brunt of adjustment to exogenous shocks and in particular the cyclical swings in world economic activity. This is vividly illustrated on Chart 2 which shows that over the years before 1975 the domestic component of GNE growth (i.e. the contribution of private final consumption plus private gross fixed capital formation to overall GNE growth) moved in cycles with the total aggregate, whereas since 1975 while the domestic component has continued to be cyclical the overall rate of GNE growth has been largely acyclical.

This immediately suggests a 'crowding-out' theory to explain changes in the relative importance of the components of GNE growth, as discussed in previous issues of AMM (for instance AMM Vol. 5 No. 5). However, on its own, the observation that the external sector crowds out the domestic sector or vice-versa is tautological and begs the question of the mechanism through which such a process can occur, and whether, for instance, the domestic private sector recently has been crowded out by the external sector or by the government sector.

In fact in its simple form the crowding out theory is not merely a tautology, it is no longer strictly applicable to the most recent behaviour of the Japanese economy. As a look at Chart 3 reveals the decline in the external component of growth (net exports) which occurred between 1980 and 1982 as a result of the worldwide recession over that period, was accompanied by a similar decline in the overall growth rate. Thus, although the domestic sector did begin to recover slightly during 1981, the recovery in this sector was not enough to offset the deterioration in net export growth, and the year-on-year GNP growth rate fell from 5.4% in the first quarter of 1980 to 2.1% by the first quarter of 1982. A glance at Chart 4 shows that

JAPAN

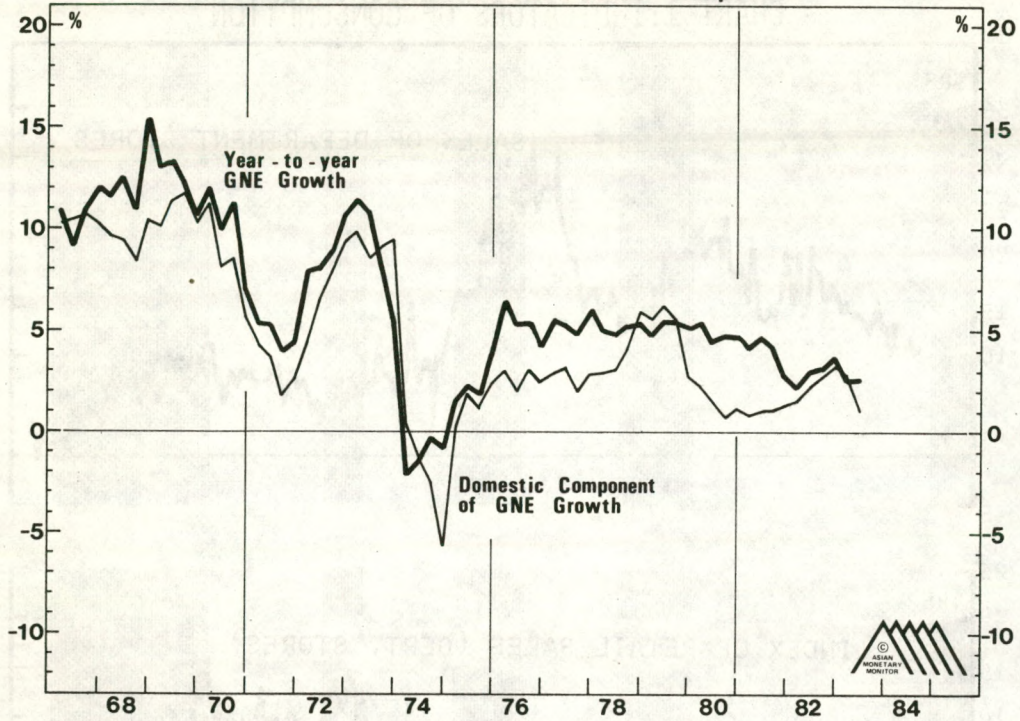
CHART 1: INDICATORS OF CONSUMPTION



Source: Japanese Economic Indicators,
Economic Planning Agency.

JAPAN

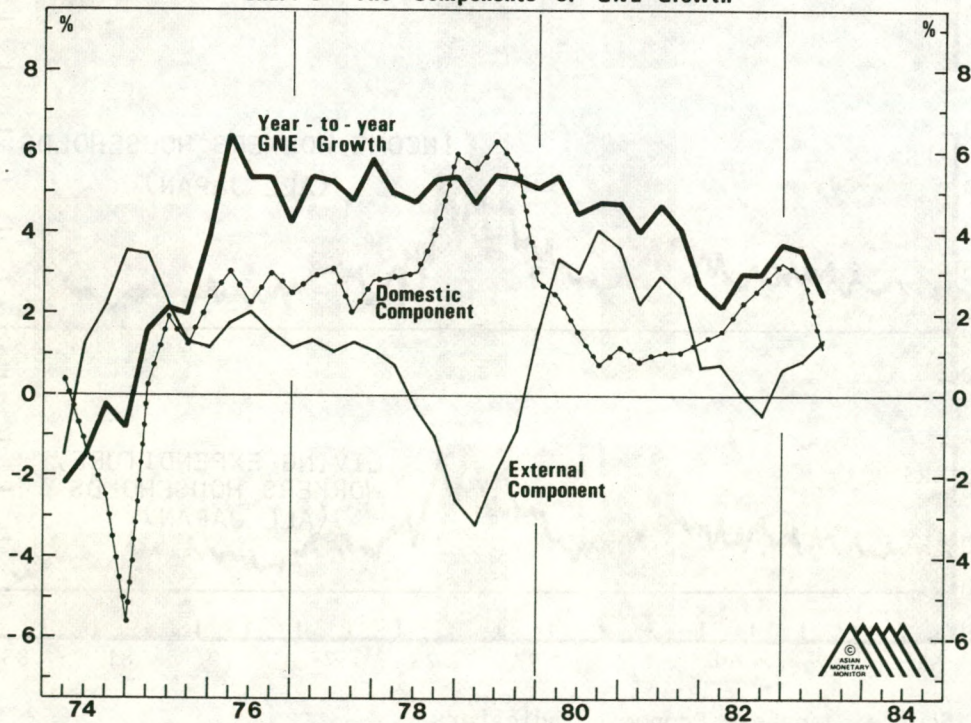
Chart 2: GNE Growth And Its Domestic Component



Notes: The 'Domestic Component' is the contribution of consumption plus private gross fixed capital formation to total GNE growth.

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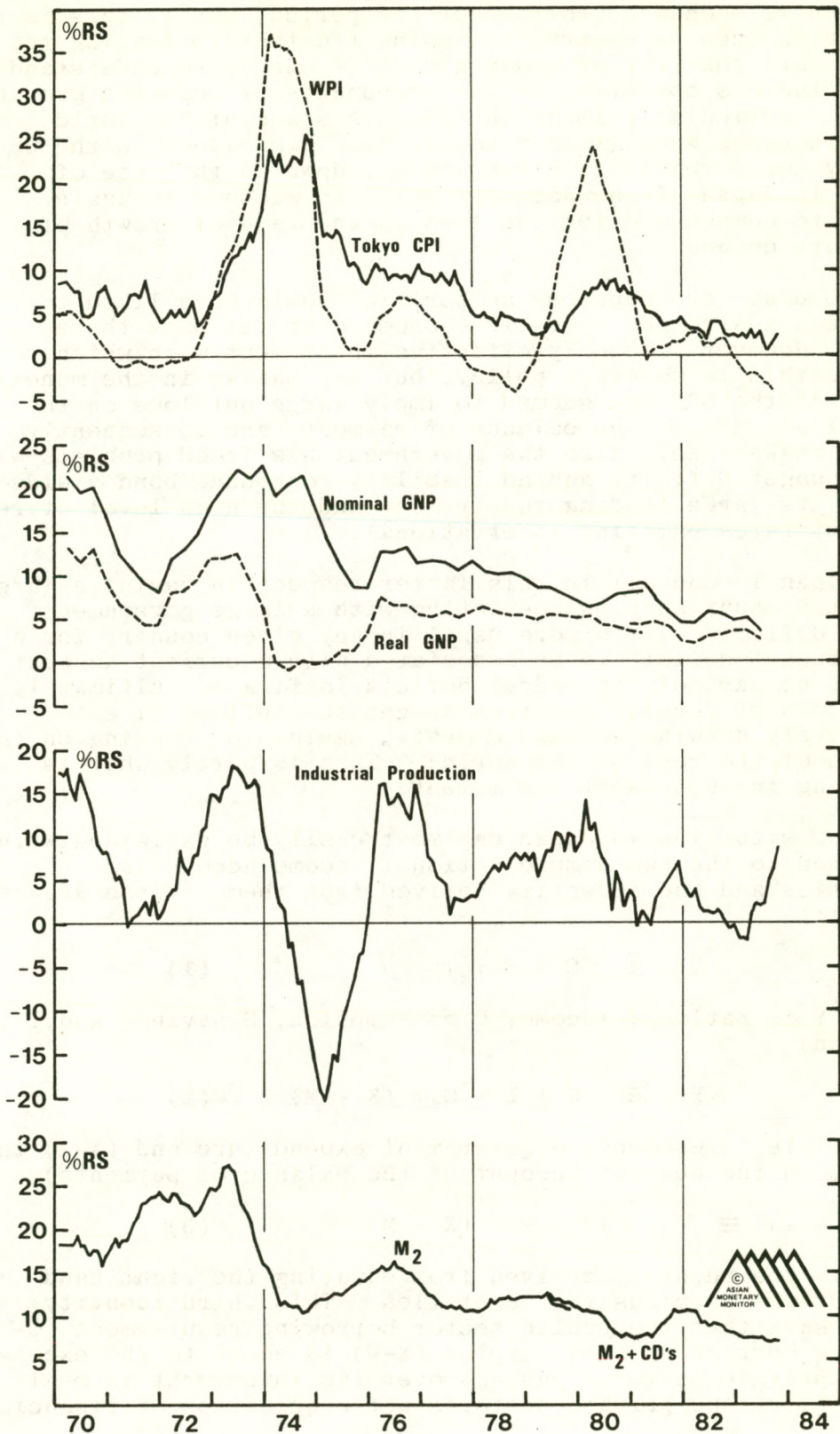
Chart 3: The Components of GNE Growth



Notes: The 'Domestic Component' is the contribution of consumption plus private gross fixed capital formation to total GNE growth.
The 'External Component' is the contribution of net exports to total GNE growth.

JAPAN

CHART 4: MONEY, OUTPUT AND PRICES



money growth declined sharply during 1979/1980 and again during 1982. This on its own could be enough to explain the behaviour of Japanese economic growth over the period, but if this is the case it is then necessary to examine the factors leading the BOJ to vary the rate of money growth if one is to understand the influences operating on the components of economic growth. This is particularly important at this stage of the world economic cycle when it is possible that a slowdown in the US economy could result in a further slowdown in the rate of growth in Japan if the Japanese domestic economy is again unable to compensate for the loss in the rate of growth of aggregate demand.

No doubt the Japanese authorities would have liked to have seen a stronger domestic economy over the past three years. However, the only effective instrument with which to achieve this is monetary policy, but any easing in the monetary stance of the BOJ has seemed to imply large outflows on the capital account of the balance of payments and consequently a much weaker yen. Also the government has faced problems with large budget deficits and an inability to reduce bond yields due to its large funding requirement and the high level of real interest rates existing internationally.

Japan is unusual in this latter respect in having a large current account surplus coexisting with a large government budget deficit. It is more usual in any given country for a large budget deficit to be associated with a current account deficit as part of the budget deficit is financed ultimately by a drawdown of foreign reserves or capital inflows (i.e. effectively drawing on past domestic savings or drawing on the savings of the rest of the world). This is partly what is happening in the USA at the moment.

The situation in Japan can most easily be explained with reference to the two simple national income accounting identities and the identity derived from them. These are as follows:

$$Y \equiv C + S + T \quad (1)$$

(where Y is national income, C consumption, S savings and T taxation)

$$Y \equiv C + I + G + (X - M) \quad (2)$$

(where I is investment, G government expenditure and (X-M) the surplus on the current account of the balance of payments)

$$\text{and } (S - I) \equiv (G - T) + (X - M) \quad (3)$$

which is the identity derived from equating the right hand sides of the previous two identities. This third identity simply says that the public sector borrowing requirement (G-T) plus the current account surplus (X-M) is equal to the excess of the private sector's savings over its investment in real assets (i.e. the private sector's net acquisition of financial

assets).

From the three simple identities above it is relatively straightforward to see that the proposition that the domestic economy (C+I) is weak relative to the total economy (Y) is the same as the proposition that the private sector's net acquisition of financial assets (S-I) is high relative to the size of the economy. This follows from the fact that consumption is the inverse of savings (from (1)) and thus if consumption and investment are relatively weak then savings must be high relative to investment.

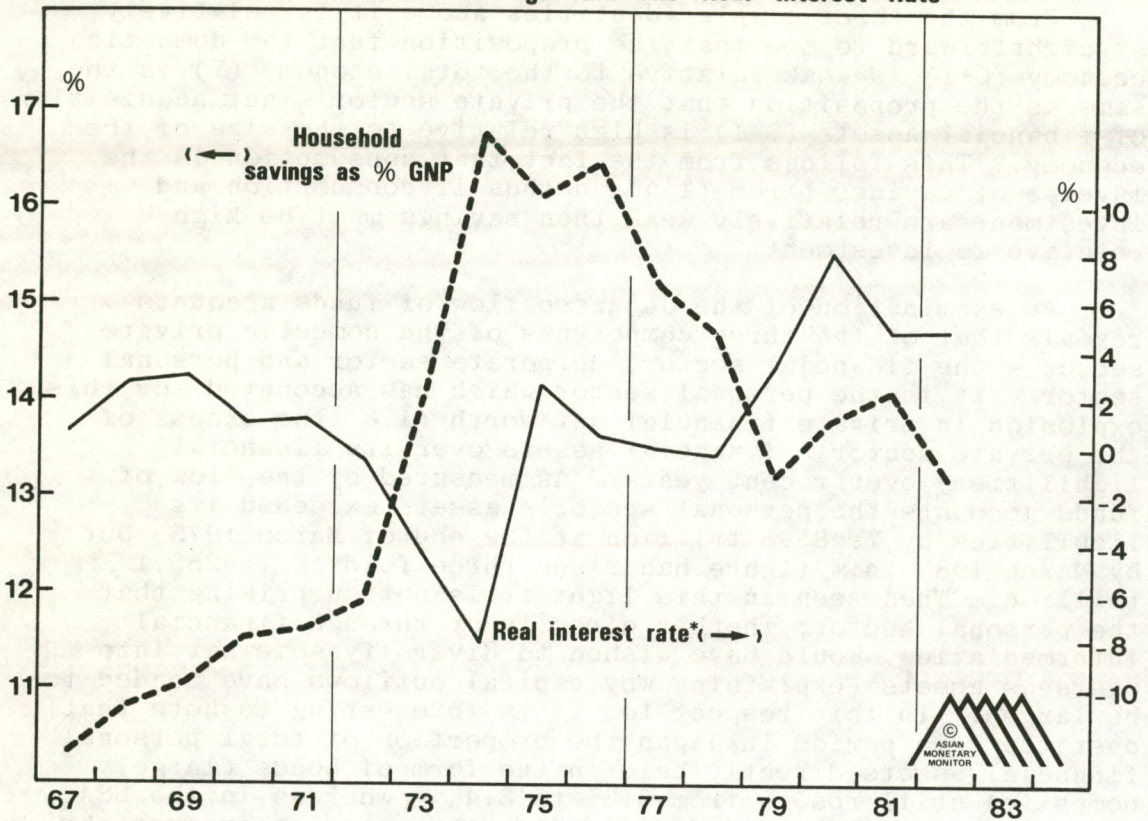
An examination of the Japanese flow of funds accounts reveals that of the three components of the domestic private sector - the financial sector, corporate sector and personal sector - it is the personal sector which has accounted for this explosion in private financial net worth (i.e. the excess of the private sector's financial assets over its financial liabilities) over recent years. As measured by the flow of funds accounts the personal sector's assets exceeded its liabilities by Yen85.5 trillion at the end of March 1975, but by March 1983 this figure had risen three fold to Yen255.1 trillion. When seen in this light it is not surprising that the personal sector, whether directly or through financial intermediaries, would have wished to diversify somewhat into overseas assets (explaining why capital outflows have tended to be large). In this respect too it is interesting to note that over the same period in Japan the proportion of total personal financial assets directly held in the form of bonds (largely domestic) still rose - from 6.8% to 8.4% - whereas in the USA, despite the magnitude of deficit-financing bond sales over the past three years, the proportion actually fell from 11.1% in 1975 to 10.6% at the end of 1982.

The stubborn weakness of the domestic private sector in terms of economic growth can therefore be seen as either a question of why the personal sector has not saved less (and hence consumed more) or, given that it has had a high marginal propensity to save, why this saving has not been directed more into investment in real assets rather than financial assets.

A closer look at the national accounts reveals that it is primarily investment, rather than consumption, which has been responsible for the sluggishness of the domestic sector of the economy since 1980. Although, as Chart 1 indicates, retail sales have remained weak the broad measure of consumption (which includes consumption of services) included in the gross national expenditure has behaved relatively normally over the last three years. In fact in 1982 consumption contributed an above-average 74% of the year's economic growth and was wholly responsible for the slight recovery in the domestic economy over 1981/1982 illustrated in Chart 3. Investment, on the other hand, has continued on a declining trend relative to overall GNE since 1979. This is noticeable not only in terms of contributions to the overall rate of economic growth, where private gross fixed capital formation has contributed negatively to economic growth since the end of 1981, but also in terms of

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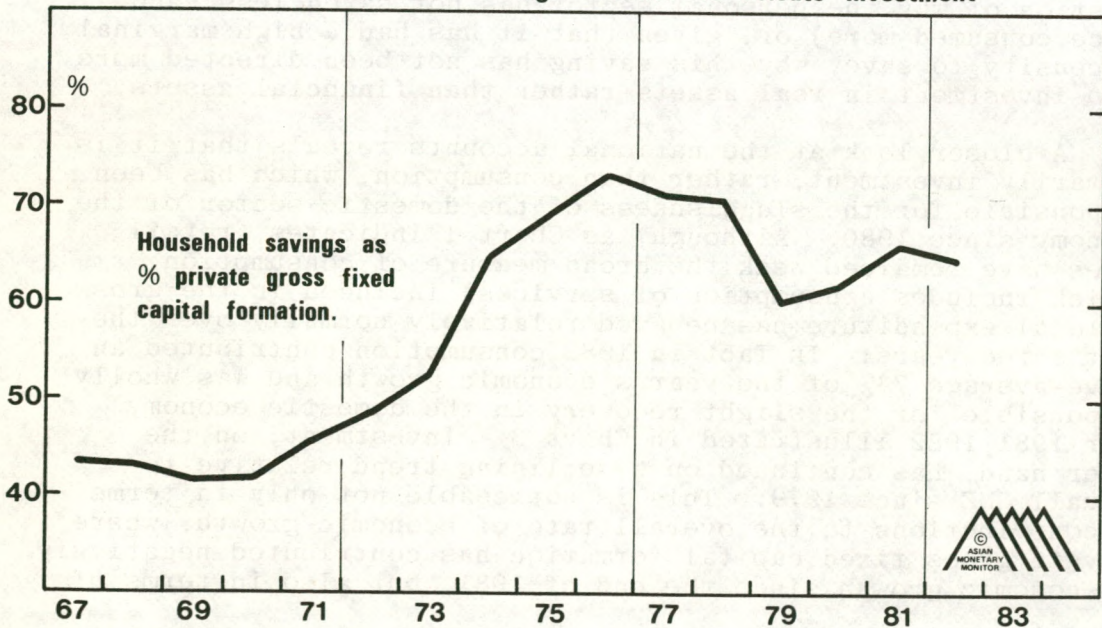
Chart 5 : Household Savings And The Real Interest Rate



*Average call money rate minus GNP Deflator growth rate

JAPAN

Chart 6 : Household Savings Relative To Private Investment



more restrained stance, pushing short US interest rates approximately one hundred and fifty basis points higher, to roughly 10%. However, it is important to recall that the Federal Reserve's present monetary guidelines are by no means restrictive when compared with previous policies, or with monetary policy in Japan. The US authorities have rebased their target growth path for M1 and now hope for between 5% and 9% annualised growth in that variable during the second half of this year. It is probable that the Federal Reserve has already tightened monetary conditions sufficiently to ensure that this (unambitious) target is achieved. This being so there is little reason to expect US interest rates to move any higher over the remainder of 1983.

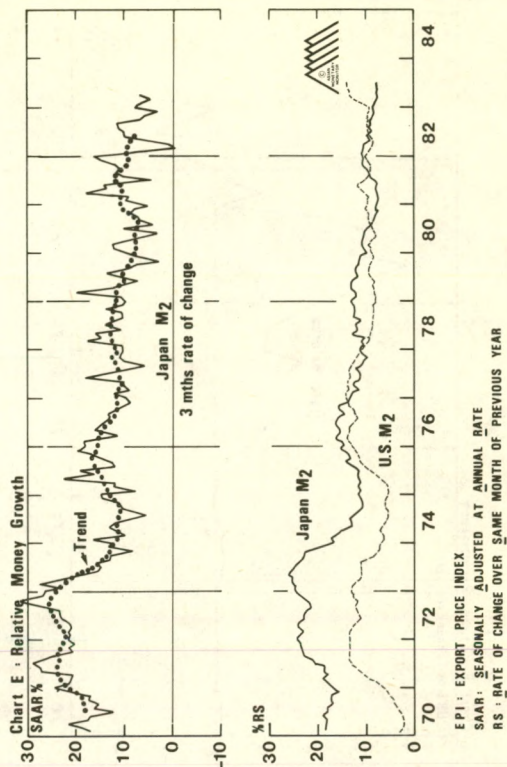
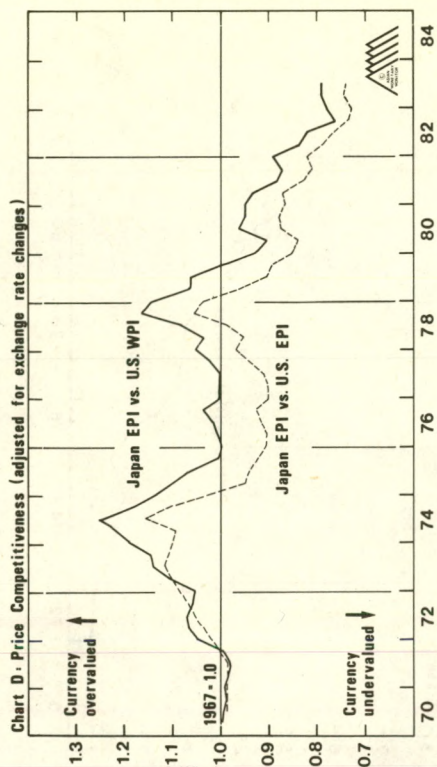
In these circumstances, the favourable fundamental outlook for the Japanese currency is likely to be reflected in a rising yen/US dollar rate in the coming months. Chart D suggests that the yen is anything up to 20% undervalued against its US counterpart and given a strong recovery in the US, this is likely to lead to a further substantial improvement in Japan's trade account (see Chart B). Indeed Japanese export growth over the last six months has outpaced import growth by over 10%. Of course trade and service flows are not the only component of the external account, but during the second quarter of 1983 large long term capital outflows measuring US\$3.726 billion were more than outweighed by a current account surplus of US\$6.014 billion.

ACTUAL FORECAST

Yen/US\$	1983	Q2	Jul. - Aug.	Q4	1984 Q1
FORECAST A				225-240	215-230
Actual Range	231.0-242.8		238.7-247.1		
FORECAST B				240-255	225-245

Forecast A assumes that US interest rates remain steady or decline over the balance of 1983.

Forecast B assumes that a further rise in US interest rates proves necessary in order to bring US monetary growth back to target.



MALAYSIAN RINGGIT

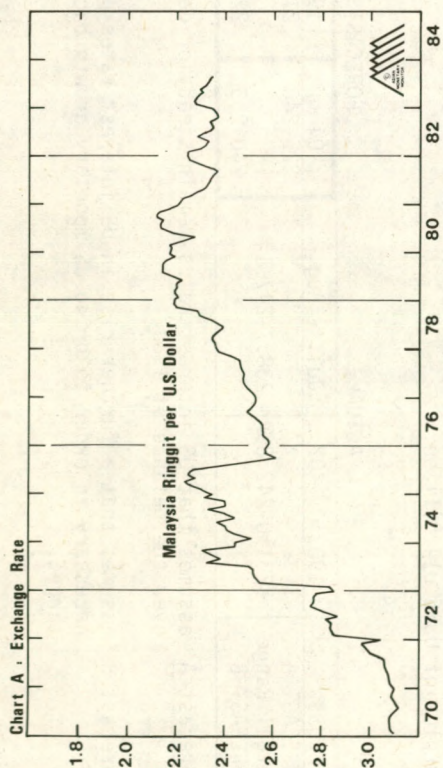


Chart B: Trade Performance
US\$ bn (annualised rate)

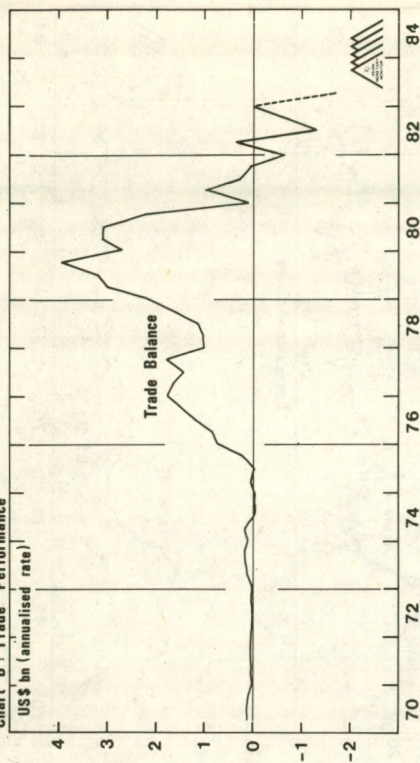
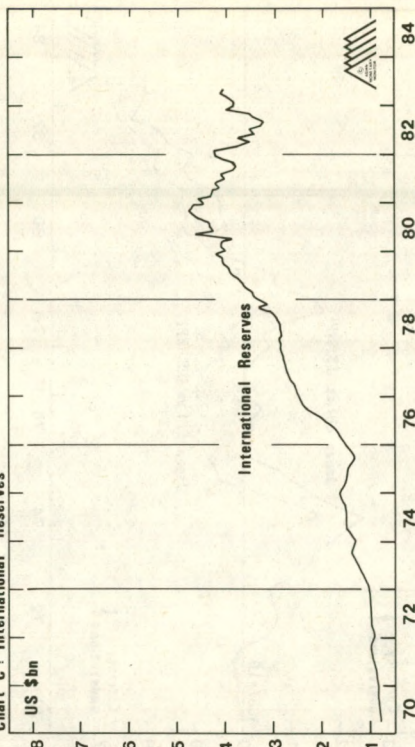


Chart C: International Reserves
US\$ bn



Prospects for the Malaysian economy have become brighter over the past few months as the prices of major commodities have risen. The price of palm oil unexpectedly surged by roughly 50% between June and August as a result of the failure of US soyabean crops because of a severe drought. Reflecting the improved outlook for the Malaysian economy the Deputy Finance Minister recently raised the official forecast for economic growth for this year to 5.8%.

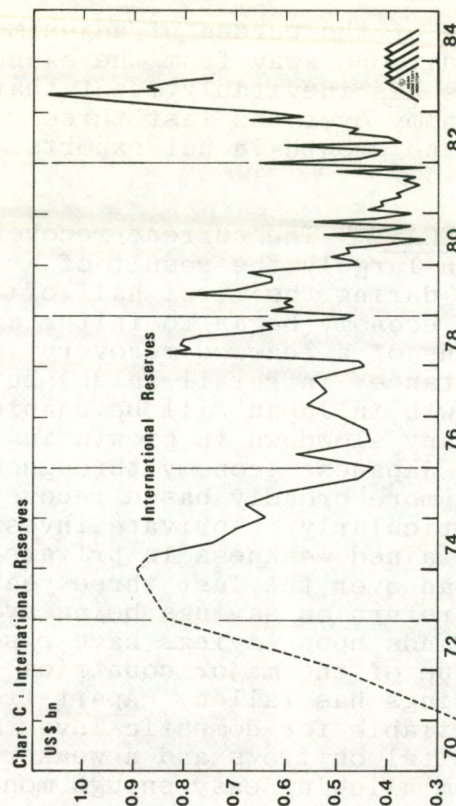
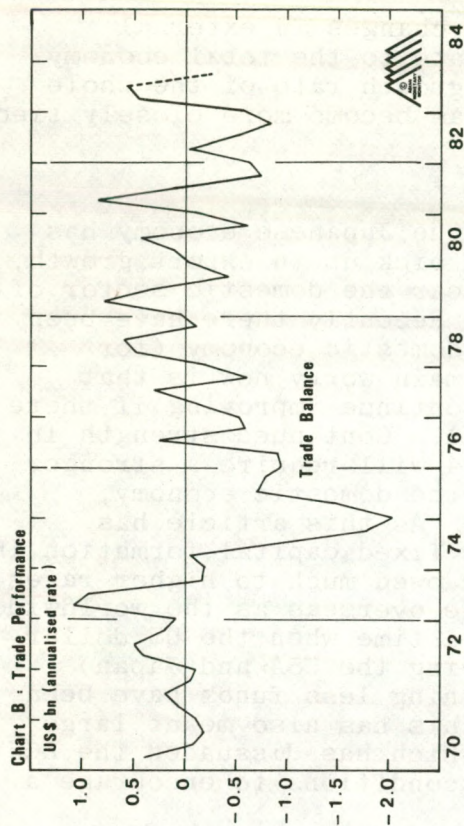
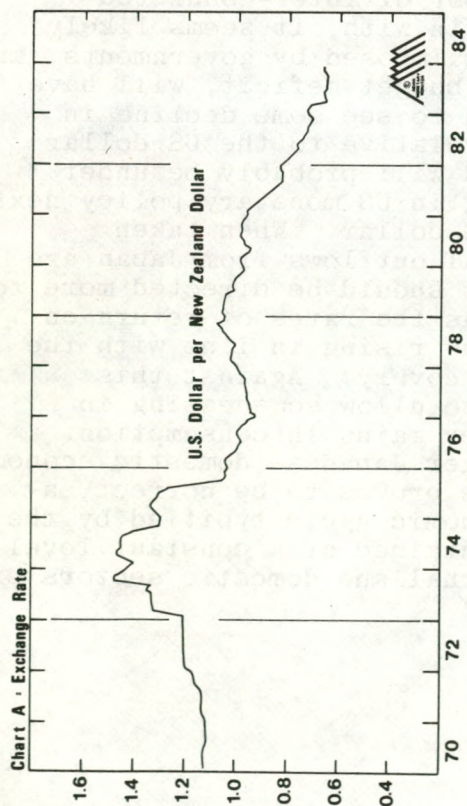
The possible danger posed by higher commodity prices is that the resulting recovery in the trade balance could be reflected in an upswing in monetary growth if the authorities continue to manage the Malaysian Ringgit rigidly against the Singapore dollar. It can be seen from Chart E that the commodity booms of 1973 and 1979 as well as the uptick in commodity prices in 1976 were all mirrored by a rapid acceleration in the money supply. There is valid cause for concern that, despite the Bank Negara Malaysia's (BNM) commitment to a sound money policy, the same may occur in this cycle if the government fails to reduce its budget deficit by a significant amount.

During the 1970's in some senses the government's fiscal position acted as an 'automatic stabiliser' with respect to the trade position's influence on the money supply. During commodity price

some of the burden of adjustment to changes in external conditions away from the exchange rate to the total economy. This has inevitably meant that the growth rate of the whole economy over the last three years has become more closely tied to the growth in net exports.

FORECAST: The current recovery in the Japanese economy has been largely the result of a strong pick up in export growth, and during the first half of this year the domestic sector of the economy began to falter again. Recently there have been signs of a renewed recovery in the domestic economy (for instance, in retail sales) but the main worry now is that growth in Japan will be unable to continue improving if there is any slowdown in growth in the USA. Continued strength in the Japanese economy throughout 1984 will require a stronger and more broadly based recovery in the domestic economy, particularly in private investment. As this article has explained weakness in private gross fixed capital formation in Japan over the last three years has owed much to higher rates of return on savings being available overseas as the worldwide demands upon savings have risen at a time when the US dollar value of the major countries' (barring the USA and Japan) savings has fallen. Apart from meaning less funds have been available for domestic investment this has also meant large capital outflows and a weaker yen which has dissuaded the BOJ from allowing easy enough monetary conditions to encourage a strong recovery in consumption.

Conditions in 1984 are likely to be such as to allow, finally, a strong recovery in the domestic sector of the Japanese economy. There are a number of inter-connected reasons for believing this. To begin with, it seems likely that the demands upon world savings imposed by governments, and in particular by the US structural budget deficit, will have probably peaked and we should begin to see some decline in government's offtake from savings relative to the US dollar value of world savings. This trend will probably be under way simultaneously with some easing in US monetary policy next year and, consequently, a weaker US dollar. When taken together this means that net capital outflows from Japan are likely to fall and domestic savings should be directed more to domestic investment, particularly as the rates of return on investment in Japan are likely to be rising in line with the broadening of the world economic recovery. Against this background the BOJ should be able to allow some easing in monetary policy, encouraging further gains in consumption. Thus in 1984 we should see a stronger Japanese domestic economy and, if the analysis laid out above proves to be correct, a return in Japan to the type of economic cycle typified by the 1975-79 period when growth was maintained at a constant level through inverse cycles in the external and domestic sectors of the economy.



The New Zealand dollar has traded in a very narrow range against the US dollar since the former was devalued by 6% on March 8th this year. The formal devaluation brought the New Zealand dollar down from US\$0.715 to US\$0.655 and it has traded in a range between US\$0.649 and US\$0.665 ever since.

During most of the past two years the Reserve Bank of New Zealand has conducted an aggressively restrictive monetary policy. A high interest rate policy coupled with the implementation of official controls on the growth of bank lending has brought the year-to-year growth in M2 down from nearly 20% at the end of 1981 to only 7.2% in June 1983 (see Chart D). Over the same period M1 growth plummeted from 15.8% to 0.2%. This squeeze on monetary growth at a time when inflation remained high, around 15%, had a predictable impact on real incomes during 1982 and real GNP fell by nearly 2% over the course of the year. Nevertheless, the benefits of the Reserve Bank's more conservative stance during 1982 are now more widely visible. Inflation has been reduced sharply, with consumer price inflation declining from 17% in June 1982 to 5.4% in June this year. This improvement in New Zealand's competitiveness, together with a reduction in import demand, has led to an improved trend in the external account (see Chart B).

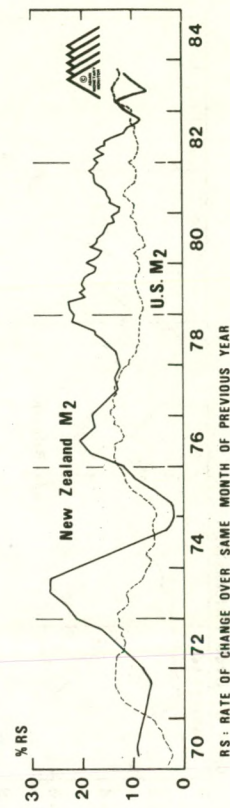
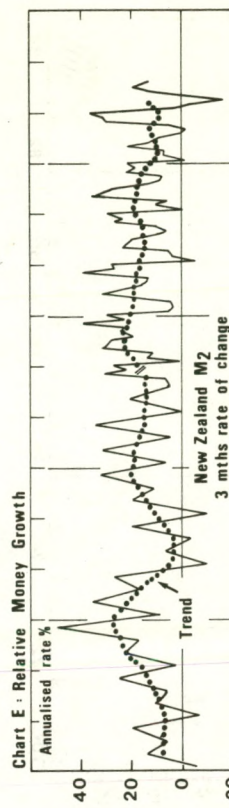
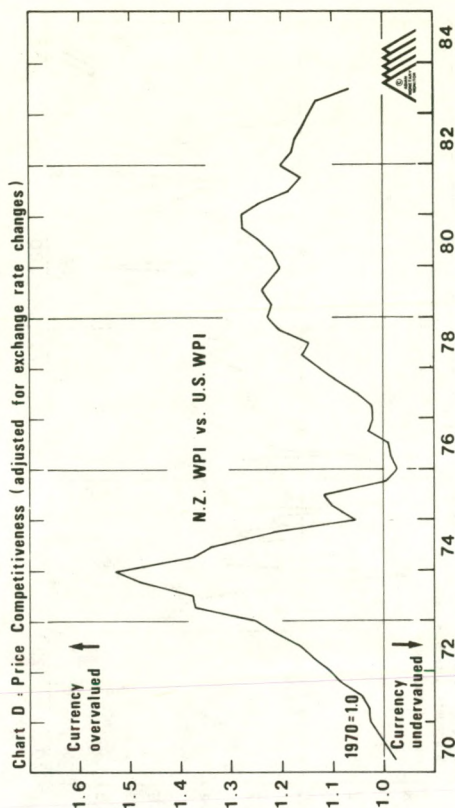
If the Reserve Bank had sustained a relatively restrictive monetary policy the longer term outlook for the New Zealand dollar would undoubtedly have improved from the persistently weakening trend evident since 1974 (Chart A). However the New Zealand government's decision on July 27th to slash the discount yields on three month Treasury Bills from 12% to 7.8% provides investors with more than adequate grounds for scepticism about the authorities' commitment to maintaining relatively low rates of inflation in the domestic economy. For to devalue and reduce domestic interest rates is generally a reliable recipe for sharply higher monetary growth. This is particularly likely to be the case when, as in New Zealand at present, there is an overall balance of payments surplus and rapid growth in holdings of international reserves.

The official monetary statistics for the third quarter of 1983 are not yet available, but when they are released we anticipate that there will prove to have been a rapid acceleration in monetary growth. If the New Zealand authorities persist with a low interest rate policy, continued rapid monetary growth will lay the foundation for a fundamentally weaker New Zealand dollar during the second half of 1984. The authorities' decision to slash domestic interest rates in July this year strongly suggests that the New Zealand dollar's recent stability against the US dollar will prove to be temporary.

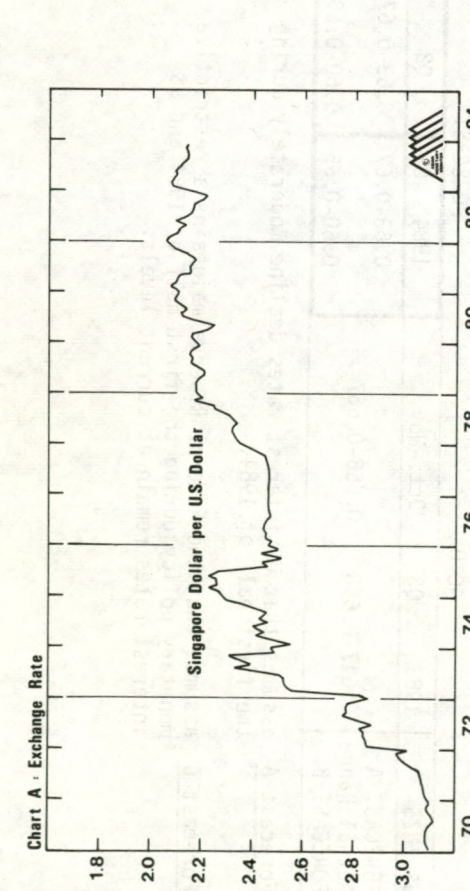
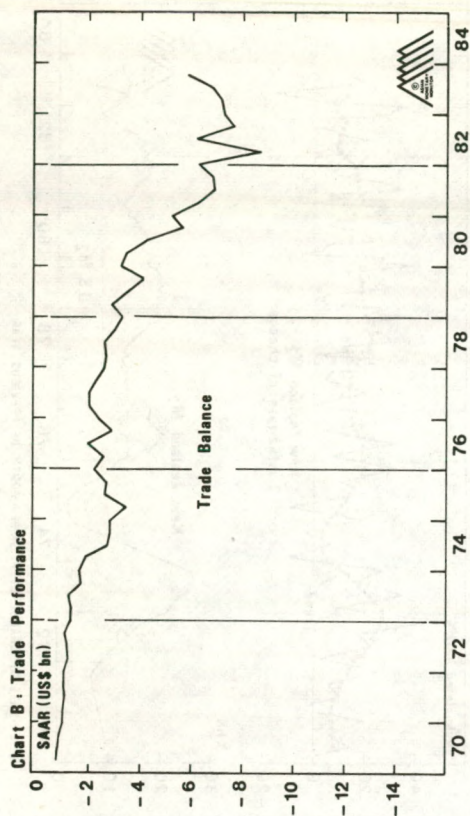
US\$/NZ\$	ACTUAL			FORECAST	
	1983	Q3	Oct.-Nov.	1984 Q1	Q2
FORECAST A					
Actual Range		0.647-0.658	0.656-0.667	0.63-0.67	0.63-0.67
FORECAST B				0.60-0.65	0.60-0.65

Forecast A assumes that US interest rates decline moderately during the first half of 1984.

Forecast B assumes that the Federal Reserve maintains a restrictive monetary policy during the first half of 1984 and US interest rates remain at current levels.

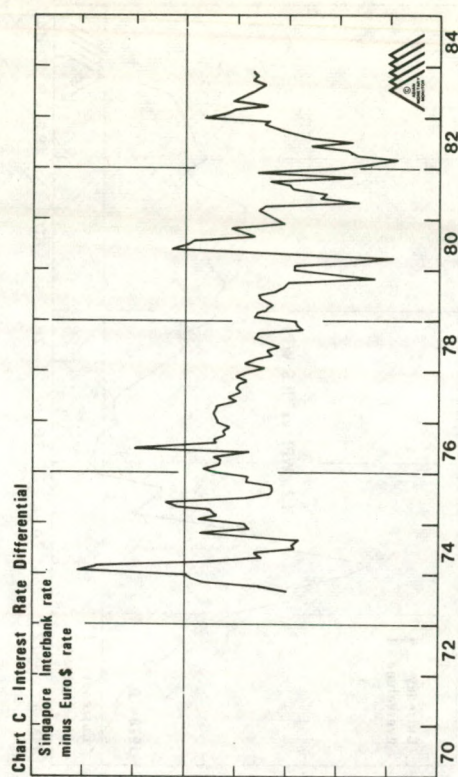


SINGAPORE DOLLAR



The Singapore dollar fell in value against the US dollar over the first seven months of 1983, but since August has remained very stable against its US counterpart, hovering around the US\$1 = S\$2.13 mark. The decline against the US dollar up to August was accompanied by a very sharp slowdown in Singapore's rate of monetary growth, September statistics showing M1 lower in absolute terms than at the end of 1982, and the three-month annualised rate of growth of M2 at zero; down from a high of 47% in October 1982.

The simultaneous occurrence of a weakening Singapore dollar and a marked decline in the rate of money growth can almost certainly be explained by a deterioration in Singapore's overall balance of payments position. Trends in the balance of payments effectively determine monetary conditions in Singapore. This is firstly because of Singapore's 'openness' in the sense that the total value of exports, imports and capital account flows is many times greater than the size of the economy. Secondly, governmental institutional arrangements mean that the government tends to be a contractionary force in monetary terms and, thirdly, the policy of the Monetary Authority of Singapore (MAS) is directed towards stabilising the exchange rate. Combined together these factors mean that relatively



small changes in net foreign currency earnings can lead to large fluctuations in money growth.

It seems likely that the combination of negative export growth, a sharp fall-off in tourist arrivals and possibly some decline in capital inflows contributed to a drop in net foreign exchange earnings over the first seven months of this year. The MAS moved to alleviate some of the contractionary impact on the money supply by allowing the exchange rate to decline from S\$2.06 in February to a low of S\$2.15 against the US dollar in August, but the authorities' desire for the Singapore dollar to be seen as a very stable currency prevented them from allowing a more rapid depreciation of the currency, and the balance of payments deterioration emerged mainly in the form of a drop in money growth.

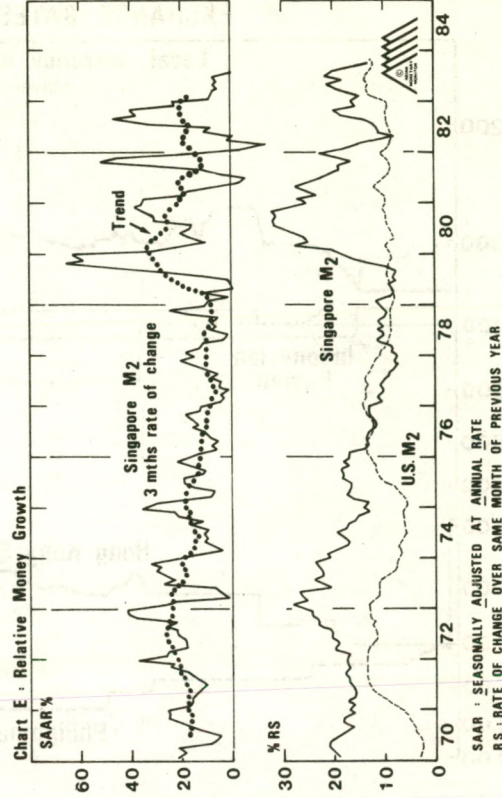
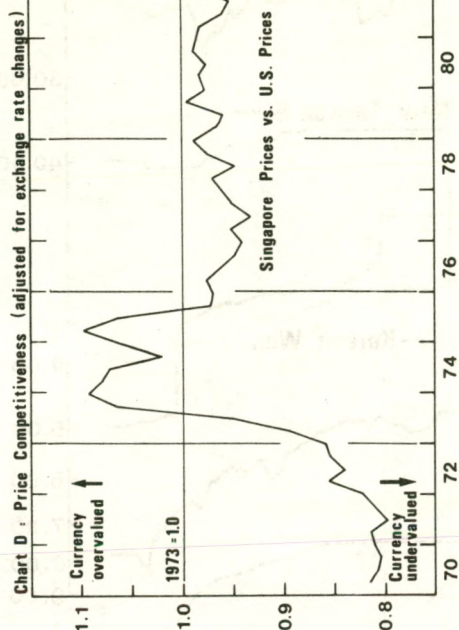
The indications are that the July/August period will prove to have been the trough in the balance of payments and of money growth. After contracting in both July and August M2 began to grow again in September. More importantly, however, August saw a very sharp improvement in the trade account stemming from a rapid improvement in exports. This improvement (Chart B) has continued up until the time of most recent statistics (October). By this time the three month annualised rate of exports growth had risen to 13.5%, after having been negative during the first half of the year. As the world economic expansion continues to filter through to S.E. Asia this improvement in Singapore's trade account and balance of payments should continue. At first this will be reflected in a recovery in money growth and later in a gradual appreciation of the exchange rate as the MAS moves to limit partially the monetary expansion.

ACTUAL FORECAST

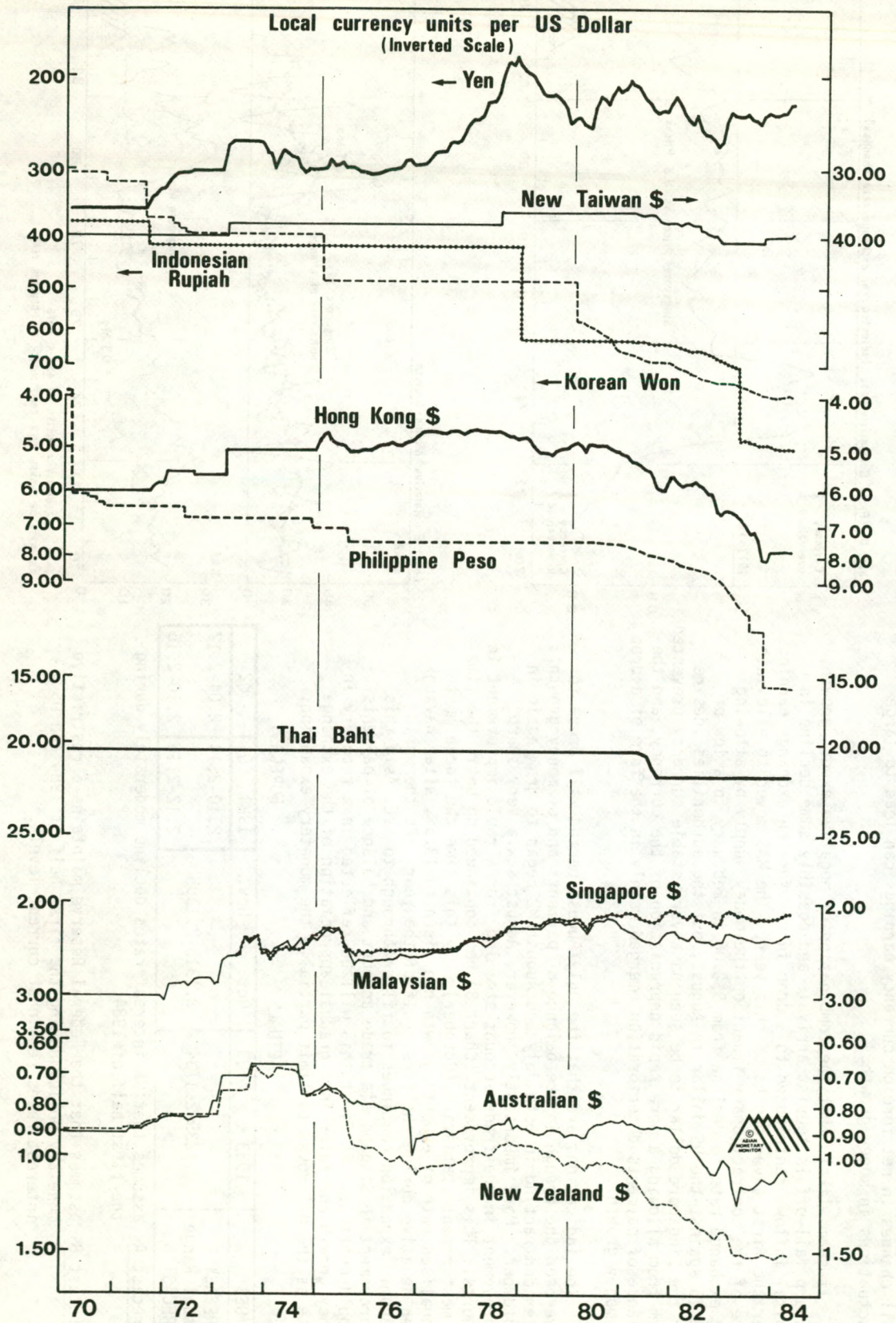
S\$/US\$	1983	Q3	Oct. - Nov.	1984	Q1	Q2
FORECAST A				2.10-2.14	2.04-2.12	
Actual Range	2.1235-2.1734		2.1315-2.1398			
FORECAST B				2.12-2.16	2.10-2.16	

Forecast A assumes that US interest rates decline moderately during the first half of 1984.

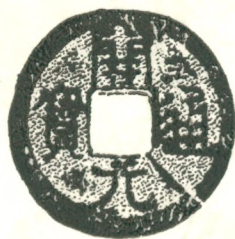
Forecast B assumes that the Federal Reserve maintains a restrictive monetary policy during the first half of 1984 and US interest rates remain at current levels.



EXCHANGE RATES IN THE FAR EAST







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